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No. ____ OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

October Term, 1997

CENTURY OFFSHORE MANAGEMENT CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

Petition for a Writ of Certiorari To The United States Court of Appeals For the Sixth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Department of the Interior is precluded from claiming royalties on non-recoupable settlement payments made by oil and gas purchasers to federal oil and gas lessees on the ground that such royalty claims exceed the DOI's statutory authority under the Outer Continental Shelf Lands Act, 43 U.S.C. § 1331, *et seq.*, particularly in light of certain DOI regulations and administrative decisions interpreting that statute.

2. Whether the United States Court of Appeals for the Sixth Circuit, in reviewing a bankruptcy court's grant of summary judgment, exceeded its appellate authority by improperly applying a *de novo* standard of review to the bankruptcy court's findings of fact rather than the required clearly erroneous standard of review.

RULE 29.6 STATEMENT

Petitioner has no parent company or nonwholly owned subsidiary to be listed pursuant to United States Supreme Court Rule 29.6.

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CENTURY OFFSHORE MANAGEMENT CORPORATION,
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For the Sixth Circuit

PETITION FOR A WRIT OF CERTIORARI

Century Offshore Management Corporation petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-19a) is reported at 111 F.3d 443 (6th Cir. 1997). The opinion of the district court is not reported and is attached hereto (App. 21a-36a). The decision of the bankruptcy court (App. 37a-52a) is reported at 185 B.R. 734 (E.D. Ky. 1995).

JURISDICTION

The judgment of the court of appeals was entered on April 14, 1997, and a timely petition for rehearing and suggestion for rehearing *en banc* was denied on July 23, 1997 (App. 20a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISIONS INVOLVED

1. The relevant provision of the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. § 1337(a) (1986), provides in pertinent part:

> (1) The Secretary is authorized to grant to the highest responsible qualified bidder or bidders by competitive bidding, under regulations promulgated in advance, any oil and gas lease on submerged lands of the outer Continental Shelf which are not covered by leases meeting the requirements of subsection (a) of section 1335 of this title. . . .The bidding shall be by sealed bid and, at the discretion of the Secretary, on the basis of--
>
> (A) cash bonus bid with a royalty at not less than 12 1/2 per centum fixed by the Secretary in amount or value of the production saved, removed, or sold;
>
> [Paragraphs (B) through (H) similarly describe possible alternative bidding mechanisms.]

2. 30 C.F.R. § 206.152(h) (1997), commonly known as the "gross proceeds" rule, provides in pertinent part:

> Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart.

3. 30 C.F.R. § 206.151 (1997) provides in pertinent part:

> Gross proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of [gas] ***.

STATEMENT

1. Petitioner's Offshore Oil and Gas Leases Under OCSLA and Royalty Obligations to DOI

Petitioner Century leases submerged lands on the outer Continental Shelf from the Minerals Management Service ("MMS"), a subagency of the Department of the Interior ("DOI"), in order to explore for and extract natural gas and crude oil.[1] The DOI leases are issued pursuant to Section 8 of the Outer Continental Shelf Land Act of 1953 ("OCSLA"), 43 U.S.C. § 1331 *et seq.*, and they incorporate the royalty provisions of Section 8(a) of OCSLA, 43 U.S.C. § 1337(a).[2] Century's royalty obligations are governed by OCSLA, the leases, and DOI regulations. Specifically, Century is obligated to pay royalties to DOI on the "amount or value of production saved, removed or sold" from the leased premises.[3]

2. Petitioner's Natural Gas Sales Contracts with Enron Gas Marketing, Inc.

Century, like other producers of natural gas, sells the natural gas produced from outer Continental Shelf leases to pipeline purchasers under natural gas sales contracts. In 1989 and 1990, Century entered into two fixed-price natural gas sales contracts (collectively, the "Fixed-Price Contracts") with Enron Gas Marketing, Inc. ("Enron").[4] The first natural

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[1] App. 38a.

[2] App. 2a-3a.

[3] *See* 43 U.S.C. § 1337 (1986) (requiring payment of royalty on the "amount or value of the production saved, removed, or sold"); 30 C.F.R. § 206.152(h) (1997) (providing that "[u]nder no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from disposition of the produced substances"); *see also* App. 40a (noting that the Century/DOI leases, which incorporate applicable federal statutes and regulations, provide for the payment of royalty on a percentage of the value of "production saved, removed or sold").

[4] App. 3a-4a.

gas sales contract ("ST 107 Base Contract"), executed on December 20, 1989, covered one of Century's leases with DOI, commonly known as South Timbalier Block 107 Lease ("ST 107 Lease").[5] The second natural gas contract ("WC 368 Base Contract") covered two of Century's leases with DOI, commonly known as the West Cameron Block 368 Lease ("WC 368 Lease"), and the Bretton Sound Block 53 Lease ("BS 53 Lease").[6]

Pursuant to the Fixed-Price Contracts, Enron agreed to either: (1) purchase certain minimum monthly quantities of the natural gas that Century produced from the leases; or (2) make non-recoupable payments to Century in each month in which Enron failed to take-and-pay for those minimum quantities of gas.[7] Under these agreements, then, Enron could avoid its obligation to purchase minimum quantities of gas from Century in one and only one way: by making a non-recoupable payment to Century.

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[5] *Id.*

[6] *Id.*

[7] *Id.* Natural gas sales contracts, take-or-pay payments, and "make-up" gas are discussed generally in the Fifth Circuit's decision in *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (1988). As that decision points out, some take-or-pay payments may eventually be refunded (*i.e.*, recouped) during a subsequent contract period by purchasing quantities of natural gas during that period in excess of the minimum purchase requirements for that period, *i.e.*, by purchasing so-called "make-up" gas. *Id.* at 1164. In other cases, the take-or-pay payment is non-recoupable, *i.e.*, the payment can never be recouped by purchasing gas in excess of the minimum purchase requirements during a subsequent contract period. *Id.* There is no dispute that the original contracts between Century and Enron provided that Enron would make *non-recoupable* payments to Century if Enron failed to take and pay for the contractual minimum quantity of gas. *See* App. 4a ("once made, Enron's payments under the take-or-pay clause were gone for good").

3. Enron's "Buy-Out" of Its Contractual Obligations Under The Fixed-Price Contracts

Sometime during 1991, Enron approached Century with a request that the parties negotiate a "buy-out" or purchase of the Fixed-Price Contracts by Enron.[8] During the negotiations that followed, Enron presented Century with a computation showing the present value of the monthly non-recoupable payments that Enron would be required to make to Century over the remaining terms of the Fixed-Price Contracts if Enron failed to purchase the required minimum monthly quantities of gas.[9] Century presented Enron with a similar calculation.[10]

On the basis of additional negotiations concerning those calculations, the parties agreed to terminate the Fixed-Price Contracts.[11] Under the termination agreement, Enron bought out its obligations under the Fixed-Price Contracts by making a lump sum payment to Century of $12,250,000.[12] As a result, Enron's future obligations under the Fixed-Price Contracts, including Enron's obligation to make monthly non-recoupable payments to Century when minimum quantities of gas were not purchased, were terminated as of January 1, 1992.[13]

Century and Enron executed new and separate natural gas purchase contracts effective January 1, 1992 (the "Spot-Price Contracts").[14] Pursuant to these new contracts, Enron had the

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[8] App. 5a.

[9] App. 39a.

[10] *Id.*

[11] App. 40a.

[12] App. 5a.

[13] *Id.*

[14] *Id.*

right, under specified conditions, to purchase certain quantities of natural gas from the ST 107, WC 368, and BS 53 Leases at "spot" prices.[15] However, under the Spot-Price Contracts -- and unlike the Fixed-Price Contracts -- Enron was *not* obligated purchase any gas whatsoever, nor was it obligated to make non-recoupable take-or-pay payments to Century if it elected not to purchase gas.[16]

4. The Proceedings Below

a. United States Bankruptcy Court Proceedings

On August 23, 1993, Century filed a voluntary petition for relief under Chapter 11 in the United States Bankruptcy Court for the Eastern District of Kentucky.[17] During the bankruptcy proceeding, the United States of America, on behalf of the MMS, filed a proof of claim for $1,855,004 in royalties on the $12.25 million non-recoupable settlement payment that Enron made to Century in order to terminate the Fixed-Price Contracts. The government alleged that royalties were due on the non-recoupable settlement payment because, according to the government, Enron made the payment not to extinguish its obligations under the Fixed-Price Contracts, but rather to receive a reduced price for gas that Enron intended to purchase under the new Spot-Price Contracts.[18]

Century contested the government's claim, and on December 16, 1994, Century filed a verified motion for sum-

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[15] *Id.* A "spot" price is by definition a market price that fluctuates over time.

[16] *Id.*

[17] The bankruptcy court had subject matter jurisdiction under 28 U.S.C. § 1334; 28 U.S.C. § 157; and Local Rule 21 of the United States District Court for the Eastern District of Kentucky.

[18] In effect, the government argued that Enron's non-recoupable $12.25 million settlement payment was "gross proceeds" accruing to Century from gas production as defined in 30 C.F.R. § 206.152(h) and 30 C.F.R. § 206.151. As discussed below, the bankruptcy court disagreed.

mary judgment with the bankruptcy court.[19] Century contended that Enron's non-recoupable $12.25 million settlement payment was not royalty-bearing for two reasons. First, the payment was in fact made to extinguish Enron's obligations under the Fixed-Price Contracts. Secondly, the government's royalty claim was barred by the DOI's own acquiescence in the Fifth Circuit decision in *Diamond Shamrock Exploration Corp. v. Hodel* ("*Diamond Shamrock*"), 853 F.2d 1159 (1988), under which non-recoupable take-or-pay payments are never royalty bearing.

On January 17, 1995, the government filed an opposition to Century's motion, claiming that there were material factual disputes regarding the nature of Enron's $12.25 million payment. It also filed an unverified cross-motion for summary judgment claiming that royalties of $1,004,422.70 were then currently due on Enron's settlement payment. On January 20, 1995, the bankruptcy court heard Century's summary judgment motion[20], announced its decision in Century's favor, and indicated that a written decision would follow.

On February 13, 1995, the bankruptcy court issued its findings of fact and conclusions of law with respect to Century's motion.[21] It held that the $12.25 million non-recoupable settlement payment was made solely to extinguish Enron's obligations under the Fixed-Price Contracts, and not for the purpose of obtaining less expensive gas from Century at a later date.[22] In light of this holding, the bankruptcy court

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[19] Century's motion was filed pursuant to Rule 7056 of the Federal Rules of Bankruptcy Procedure, which incorporates Rule 56 of the Federal Rules of Civil Procedure and its pertinent standards.

[20] Only Century's motion was fully briefed at the time of the hearing. Thus, the issues raised only by the government's cross-motion, such as the amount (if any) of its royalty claim, have not been fully briefed or heard by the bankruptcy court or the district court.

[21] App. 37a-52a.

[22] App. 43a.

found that the government's royalty claim was barred by *Diamond Shamrock*, which had established earlier that non-recoupable take-or-pay payments were not royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a).[23] The court further held that for many years after *Diamond Shamrock*, the government -- through amendments to its royalty regulations and through administrative rulings -- had acquiesced in that decision.[24]

b. United States District Court Proceedings

On January 25, 1995, the government appealed the final judgment of the bankruptcy court to Federal District Court for the Western District of Kentucky, contending that the bankruptcy court had improperly granted summary judgment for Century because material facts concerning Enron's settlement payment were in dispute. In addition, the government contended that the district court should reverse the bankruptcy court on the basis of the district court decision in *Independent Petroleum Ass'n of Am. v. Babbit* ("*IPAA*"), Nos. 93-2544, 94-2123 1995 WL 431305 (D.D.C. June 14, 1995), which had

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[23] As construed in *Diamond Shamrock*, "production" for royalty purposes means the actual physical severance of the mineral from the formation. 853 F.2d at 1168. The *Diamond Shamrock* court did not consider non-recoupable take-or-pay payments to be part of the "amount or value of production saved, removed or sold" from the leased premises, as stated by Section 8(a) of the OCSLA, 43 U.S.C. 1337(a). *Id.* at 1163. Rather, the Fifth Circuit held that the non-recoupable payments were compensation to the oil and gas producer for market risks that were not shared by the royalty owner, and thus were not royalty bearing. *Id.* at 1165, 67.

[24] App. 43a-46a. The bankruptcy court additionally concluded that the government's interpretation of the "gross proceeds" rule to require the payment of royalties on Enron's settlement payment would produce the same unreasonable results -- including undeserved royalty windfalls to the government and a distortion of the concept of "fair market value" upon which its royalty regulations are based -- which led the Fifth Circuit in *Diamond Shamrock* to reject an identical interpretation of the "gross proceeds" rule as arbitrary and capricious. App. 48a-50a. The bankruptcy court further found that the government's royalty claim (1) violated the rulemaking requirements of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553, and (2) was unlawfully retroactive. App. 47a, 50a.

held that non-recoupable settlement payments could be royalty bearing in certain instances.[25]

On August 4, 1995, the district court denied the government's appeal.[26] The district court affirmed that the material facts on which Century's motion for summary judgment was based were not in dispute and that those facts established that Enron's $12.25 million non-recoupable settlement payment was made to extinguish its obligations under the Fixed-Price Contracts.[27] In addition, the district court affirmed the bankruptcy court's determination that the government's royalty claim was barred by *Diamond Shamrock*, particularly because the government had acquiesced in that decision.[28] The district court also affirmed the bankruptcy court's rejection of the royalty claim for the additional, independent reasons that (1) such a claim would produce absurd results rendering the "gross proceeds" rule arbitrary and capricious; and (2) the claim was unlawfully retroactive.[29] Accordingly, the district court also granted summary judgment in favor of Century.[30]

c. Proceedings in the United States Court of Appeals for the Sixth Circuit

The government thereafter appealed the district court's decision to the United States Court of Appeals for the Sixth

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[25] As discussed below, the United States Court of Appeals for the District of Columbia later reversed the district court's decision in *IPAA*. *See* 92 F.3d 1248 (D.C. Cir. 1996).

[26] App. 21a-36a.

[27] App. 30a.

[28] App. 30a-31a.

[29] App. 31a-34a. The district court, however, reversed the bankruptcy court's holding that the royalty claim violated the rulemaking requirements of the APA. App. 34a-35a.

[30] App. 36a.

Circuit. While the government's appeal was pending in the Sixth Circuit, the United States Court of Appeals for the District of Columbia Circuit reversed the district court's decision in the *IPAA* case. 92 F.3d 1248 (D.C. Cir. 1996). In its decision, the D.C. Circuit found that the government had acquiesced in *Diamond Shamrock*, which held that non-recoupable take-or-pay payments are not royalty bearing. In light of this fact, the D.C. Circuit found that there was no rational basis for the government's policy of demanding royalties on non-recoupable payments made in settlement of non-recoupable take-or-pay obligations. *Id.* at 1258-60.

Notwithstanding the D.C. Circuit's decision in *IPAA*, on April 14, 1997, the Sixth Circuit issued a decision reversing the summary judgment that had been entered by the bankruptcy court and affirmed by the district court. App. 1a-19a. In that decision, the panel neither reviewed the bankruptcy court's findings of fact under a clearly erroneous standard -- as it was required to do -- nor did it even discuss those findings. Rather, it asserted that in order to determine whether Enron's settlement payment was royalty bearing, it would have to view the transaction "as a whole, as economic reality requires." App. 13a.

The panel then made a *de novo* review of the "whole" transaction -- including both fact and law -- and concluded that Enron's settlement payment was an advance payment for gas, notwithstanding the contrary factual findings of the bankruptcy court.[31] Although there were no factual findings in the record from the proceedings below to support such a conclusion, the panel then held that "the [$12.25 million] payment is royalty-bearing because, like an advance payment, it is tightly linked to 'production sold' later." App. 13a.

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[31] "[W]e hold that the lump sum payment contemplated and was the cause of new gas sales to be delivered in the future, where the parties intended a continuing relationship, and where much of the gas identified in the original contracts was delivered under the replacement contracts. The lump sum payment behaved as an advance payment under a substituted requirements contract." App. 9a.

In its opinion, the panel also reversed the bankruptcy court's conclusion that the government royalty claim was barred by *Diamond Shamrock*. According to the panel, *Diamond Shamrock* did not control the outcome of this dispute and had not been acquiesced in by the government.[32] Moreover, the panel refused to follow the reasoning of the D.C. Circuit in *IPAA*, claiming only that the cases involved different facts. App. 15a.

Petitioner filed a timely petition for rehearing and suggestion for rehearing *en banc* by the Sixth Circuit on June 4, 1997, which was denied on July 23, 1997.

REASONS FOR GRANTING THE PETITION

1. Introduction and Summary

This case presents a simple, discrete and extremely significant question that ought to be decided by this Court: whether a non-recoupable settlement payment made by an oil or gas purchaser to an OCSLA lessee is royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a), particularly in light of certain post-*Diamond Shamrock* regulations and administrative decisions interpreting that statute. In a pleading it filed in connection with the *IPAA* case, the government itself acknowledged the "exceptional" importance of this issue.[33] Specifically, at stake is the "government's ability to secure [, or federal oil and gas lessees' ability to retain,] several hundred millions of dollars in royalties on federal and Indian oil and gas lease production related to roughly *$4.68 billion* worth of contract settlement payments received by federal and Indian lessees between 1986 and 1992" (emphasis added).[34]

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[32] App. 11a-13a.

[33] The government filed a Petition for Rehearing and Suggestion for Rehearing *En Banc* with the D.C. Circuit which was denied on November 21, 1996.

[34] *See id.*

As discussed below, this Court should grant *certiorari* for two primary reasons. First, a uniform, national rule is necessary in light of the direct conflict between United States Courts of Appeals on this issue. Second, regardless of whether a non-recoupable settlement payment is or is not royalty bearing, the Sixth Circuit's decision in this case necessarily rested on factual findings that it was not, as a matter of law, entitled to make.

2. There is a Clear Conflict Among United States Courts of Appeals on This Important Issue of Law

The decision below creates an indisputable conflict between at least two United States Courts of Appeals regarding the administration of federal oil and gas leases. On one hand, the D.C. Circuit, in overturning the district court's decision in *IPAA*, stated unequivocally that the government -- through a consistent string of administrative decisions and regulations -- had acquiesced in the *Diamond Shamrock* decision. 92 F.3d at 1257-58. The D.C. Circuit then held that *Diamond Shamrock*, which firmly established that non-recoupable take-or-pay payments were not royalty bearing, applied with equal force to non-recoupable settlements of future, individual take-or-pay payments. 92 F.3d at 1260.[35] The D.C. Circuit emphasized that the government's right to royalties does not depend on whether a non-recoupable settlement payment can be attributed to gas that is sold after an original gas sales contract is terminated. Rather, the government's right to royalty depends *exclusively* on whether the settlement payment is recoupable or non-recoupable: "[U]nlike the recoupable take-or-pay payment, a nonrecoupable settlement payment is *never* credited as payment for any gas actually severed from the ground." 92 F.3d at 1259 (emphasis in original).

Meanwhile, the Sixth Circuit in this case held that the government had not acquiesced in the *Diamond Shamrock* decision, that *Diamond Shamrock* was not controlling author-

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[35] In light of the government's acquiescence in *Diamond Shamrock*, the D.C. Circuit found that the government "failed to give a nonarbitrary reason for treating the two types of payments differently" as required under APA § 706(2)(A) review. 92 F.3d at 1259.

ity, and that in certain instances, non-recoupable settlement payments *can* be royalty bearing. Specifically, the Sixth Circuit panel held that the non-recoupable $12.25 million settlement payment rendered by Enron to Petitioner Century was in fact royalty bearing because the payment (1) "contemplated and was the cause of new gas sales to be delivered in the future"; and (2) was so "tightly linked" to any production to be purchased under the Spot-Price Contracts that it served the same purpose as an "advance payment" for gas. App. 9a, 13a. The Sixth Circuit therefore embraces the notion that a non-recoupable settlement payment *can* be credited as payment for gas actually severed from the ground -- albeit gas severed at some later date -- and thus *can* be royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a).

The conflict between the Sixth Circuit and D.C. Circuit is readily apparent. Under the Sixth Circuit rule in this case, the recoupability or non-recoupability of a settlement payment is immaterial for purposes of determining whether a royalty is due on such a payment. If a non-recoupable settlement payment acts like an "advance payment for gas," it is royalty bearing. Under D.C. Circuit law as established in *IPAA*, the question of recoupability is not only critical, but dispositive -- a non-recoupable settlement payment is *never* royalty bearing, even if gas is later sold to the party making the non-recoupable settlement payment.

The fact that these two decisions are in such stark contrast is sufficient reason for this Court to grant *certiorari*. In the past, this Court has seen fit to grant *certiorari* merely "to forestall a *possible* conflict in the lower courts" concerning issues of statutory interpretation. *See Dawson Chem. Co. v. Rohm & Haas Co.*, 448 U.S. 176, 185 (1980) (emphasis added). Here, such a conflict already exists and is certain to intensify if left unaddressed. In fact, after the D.C. Circuit issued its opinion in *IPAA* and remanded the case back to district court, the government sought and received an order confirming that it was free to continue to litigate this issue against individual IPAA members in

the hope of prevailing along the lines of the Sixth Circuit's opinion on buyouts in this case.[36]

In another *IPAA* pleading filed after the Sixth Circuit decision in this case, the government itself conceded that "the [MMS] now faces two competing views...in deciding how to proceed on these matters."[37] Absent a uniform, national rule here, federal oil and gas lessees will be either exposed to, or completely immune from, MMS royalty rights on non-recoupable settlement payments depending solely on the jurisdiction in which a royalty claim is litigated. The issue is therefore ripe for this Court's review.

If *certiorari* is granted, petitioner would argue that the government's royalty claim impermissibly exceeds the MMS's statutory, regulatory, and contractual authority. Specifically, Petitioner would assert that the D.C. Circuit correctly found the government's royalty claims on non-recoupable settlement payments to be barred because of its own acquiescence in the Fifth Circuit's *Diamond Shamrock* decision. Petitioner will also show that for many years after *Diamond Shamrock*, both MMS and DOI, through regulatory

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[36] *IPAA* was litigated jointly by plaintiffs Samedan Oil Corporation and the Independent Petroleum Association of America, a large trade association of petroleum businesses and organizations. *See* 92 F.3d at 1253-55. Samedan was seeking review of an MMS royalty assessment of $20,000 on a non-recoupable settlement payment made to Samedan by one of its own gas purchasers. *Id.* The government, desiring a mechanism for a single, national rule on the non-recoupable settlement royalty question, agreed that Samedan's case would proceed as the "test case" for this issue. *Id.* at 1254. However, after the D.C. Circuit's ruling, the government successfully argued to the district court that because of certain jurisdictional defects, the holding of *IPAA* should not apply to individual IPAA members -- except Samedan -- and that the government was free to litigate this same issue against such IPAA members in the D.C. Circuit or anywhere else. *See Independent Petroleum Ass'n of Am. v. Babbit*, 971 F. Supp. 19 (D.D.C. 1997) (granting in part the government's motion for an order implementing the mandate of the District of Columbia Circuit).

[37] MMS' Reply To Plaintiff's Opposition To MMS' Motion for Entry of Order Implementing Mandate of the D.C. Court of Appeals, at 2 (filed May 30, 1997).

amendments and agency case law, *repeatedly* took the position that under the holding of *Diamond Shamrock*, non-recoupable payments of exactly the type at issue in this case were *not* royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a). This Court should therefore ensure that the government defers to its own post-*Diamond Shamrock* interpretation of that statute.[38]

3. The Sixth Circuit Improperly Applied a *De Novo* Standard of Review to the Bankruptcy Court's Findings of Fact

Even if, as the Sixth Circuit has held, non-recoupable settlement payments can be royalty bearing under certain circumstances, the Sixth Circuit panel, in deciding that such circumstances were present in this case, improperly usurped the bankruptcy court's judicial responsibilities by applying a *de novo* standard of review to the bankruptcy court's findings of fact. This Court should accept review to prevent the Sixth Circuit from unabashedly exceeding its appellate authority.[39]

The panel in this case applied a standard of review to the bankruptcy court's factual findings that squarely conflicts with the clearly erroneous standard of review adopted by at least two other panels of the Sixth Circuit.[40] As noted above,

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[38] As the D.C. Circuit noted in *IPAA*, "[u]nder *Chevron* [*U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984)], DOI's interpretation of the gross proceeds rule is held only to a standard of reasonableness, but the interpretation must be reasonable *in light of DOI's adoption of Diamond Shamrock*. Under APA § 706(2)(A) review, the [decision to claim royalties on non-recoupable settlements] must satisfy the arbitrary and capricious standard insofar as it treats contract settlement payments differently from the way it treats take-or-pay payments under *Diamond Shamrock*" (emphasis in original). 92 F.3d at 1258.

[39] Century also believes the Sixth Circuit's factual findings are wholly unsupported by the record. However, even if this were not the case, the Sixth Circuit was not entitled to make *any* findings of fact using a *de novo* standard.

[40] *See In re Moreland*, 21 F.3d 102, 104 (6th Cir. 1994); and *In re Batie*, 995 F.2d 85, 88 (6th Cir. 1993).

on the basis of uncontested evidence submitted by Century, the bankruptcy court found that Enron's settlement payment was made to extinguish its non-recoupable take-or-pay obligations under the Fixed-Price Contracts and, as a result, the settlement payment was *not* an advance payment for gas to be bought at a reduced price under the Spot-Price Contracts. Ignoring these findings, the Sixth Circuit panel engaged in a *de novo* factual review of the "economic reality" of the transaction. App. 13a.

The panel stated in its own opinion that resolution of the government's royalty claim required the panel to decide whether Enron's payment "contemplated and was the cause of new gas sales to be delivered in the future"; and whether the settlement payment was so "tightly linked" to any production to be purchased under the Spot-Price Contracts that it served the same purpose as an "advance payment" for gas. App. 9a, 13a. However, these are the same factual matters the bankruptcy court found to be undisputed when it was decided that the payment was made to extinguish Enron's future take-or-pay obligations. This Court has expressly and repeatedly admonished courts of appeals for engaging in exactly the type of improper, *de novo* fact finding that marks the instant case. *See Icicle Seafoods, Inc. v. Worthington*, 475 U.S. 709 (1986)[41]; *Amadeo v. Zant*, 486 U.S. 214 (1988)[42]. Moreover, the panel's undisputed authority to review conclusions of law

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[41] As this Court noted in *Icicle Seafoods*, "[i]f the Court of Appeals believed that the District Court had failed to make findings of fact essential to a proper resolution of the legal question, it should have remanded to the District Court to make those findings. If it was of the view that the findings of the District Court were 'clearly erroneous' within the meaning of Rule 52(a), it could have set them aside on that basis. If it believed that the District Court's factual findings were unassailable, but that the proper rule of law was misapplied to those findings, it could have reversed the District Court's judgment. *But it should not simply have made factual findings on its own.*" 475 U.S. at 714 (emphasis added).

[42] A district court's lack of precision in factual findings is "no excuse for the Court of Appeals to ignore the dictates of Rule 52(a) and engage in impermissible appellate factfinding." 486 U.S. at 227-28.

de novo did not permit the panel to engage in *de novo* review of factual findings simply because some factual issues in this case may have been intertwined with legal ones.[43] *See In re Batie*, 995 F.2d 85, 88 (6th Cir. 1993) ("if a question is a mixed question of law and fact, then we must break it down into its constituent parts and apply the appropriate standard of review for each part"). For the same reason, the panel cannot justify its findings on the ground that it was entitled to make a *de novo* review of the bankruptcy court's decision to grant summary judgment. If the bankruptcy court erred in finding that material factual matters -- such as whether Enron's settlement payment could be "tightly linked" to future gas sales -- were not in dispute, the proper course of action was to remand the matter to the bankruptcy court for trial rather then to make new appellate findings of fact about the "economic reality" behind Enron's settlement payment.[44]

In sum, this Court should accept review in order to provide much-needed guidance to federal courts, DOI, and all federal oil and gas lessees regarding an important issue of administrative law. In addition, this Court should ensure that petitioner's interests are not unnecessarily and irreparably prejudiced simply because the court of appeals decided to impose its own factual findings by judicial fiat.

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[43] The panel's findings could not possibly be rationalized as purely legal conclusions regarding contract or statutory construction, such as the proper interpretation of the royalty provisions of OCSLA. This royalty dispute, as framed by the Sixth Circuit, requires resolution of at least mixed questions of law and fact, such as whether Enron's payment was "tightly linked" to its purchases under the Spot-Price Contracts.

[44] *See Icicle Seafoods*, 475 U.S. at 714 (if trial court fails to make findings of fact essential to decision, remand is necessary).

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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ELECTRONIC CITATION: 1997 FED App. 0124P(6th Cir.)
File Name: 97aO124p.06

No. 95-6320

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

In re: CENTURY OFFSHORE MANAGEMENT CORPORATION,

Debtor.

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

CENTURY OFFSHORE MANAGEMENT CORPORATION,

Defendant-Appellee.

ON APPEAL from the United States District Court
for the Eastern District of Kentucky

Decided and Filed April 14, 1997

Before: MERRITT, JONES, and COLE, Circuit Judges.
MERRITT, Circuit Judge.

SUMMARY

This case arises from the bankruptcy of Century Offshore Management Corporation, a natural gas producer and the lessee of federally-owned submerged lands in the Gulf of Mexico. Century sold gas to Enron Gas Marketing, Inc. under five-and five-and-a-half-year, fixed price contracts. The Minerals Management Service of the United States Department of the Interior seeks to obtain $1,855,004 in royalties on a $12,250,000 lump sum payment Enron made to Century to terminate these contracts and replace them with new contracts based on current, floating market prices. The bankruptcy and district courts denied the government's royalty claim because they concluded that the lump sum payment was not a payment for the "production" of gas but merely a settlement payment designed simply to terminate the original contracts. The issue of statutory interpretation before us is whether this lump sum payment is properly attributable to "the amount or value of the production [of natural gas] saved, removed, or sold" under § 1337 of the Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331-1356 (1996). We conclude that the transaction, viewed as a whole, was clearly linked to gas "production saved, removed or sold," and we therefore reverse the decision of the courts below. An up-front payment made in exchange for a substituted contract that changes the price of the old contract, followed by new purchases, is a sufficient cause of new production of gas to qualify as "production sold" under the Act.

I.

In the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. §§ 1331-1356 (1996), Congress authorized the Department of the Interior to issue leases providing for the development of federal oil and gas resources on submerged lands on the outer continental shelf and gave the Department the authority to prescribe rules and regulations necessary to carry out the Act's leasing provisions. 43 U.S.C. § 1334(a) (1996). Since 1982, the Secretary of the Interior has

delegated the administrative responsibility for outer continental shelf leases to the Minerals Management Service.

The Act authorizes the Department of the Interior to grant oil and gas leases to "the highest responsible qualified bidder" and presents a menu of payment approaches from which the Department may choose before the bidding begins. *Id.* § 1337(a)(1). The first of these options -- the one used in the instant case -- provides for a royalty of a fixed percentage of "the amount or value of the production saved, removed, or sold" by the lessee. *Id.* § 1337(a)(1)(A)

The Department of the Interior has the sole authority to prescribe regulations necessary to carry out the provisions of the Act. *Id.* § 1334(a). As part of its administration of the Act, the Department has adopted the "gross proceeds" rule, a broad view of "the amount or value of . . . production." Under the Department's interpretation, "under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances." 30 C.F.R. 206.152(h) (1996). The Department has applied the "gross proceeds" rule to offshore leases since its initial implementation of the Act. It has also, in turn, adopted a broad definition of "gross proceeds": "Gross proceeds . . . means the *total monies and other consideration* accruing to an oil and gas lessee for the disposition of the oil [or gas] produced." 30 C.F.R. 206. 151 (1996) (emphasis added).

Century, the debtor in this case, acquired working interests in the leases at issue in this litigation -- known as West Cameron Block 368, South Timbalier Block 107, and Breton Sound Block 53 -- in 1987, 1989, and 1990. All are located in the Gulf of Mexico off the coast of Louisiana. All of these leases incorporate the "amount or value of production saved, removed or sold" language of the statute. ST 107 Lease at 2 (J.A. at 60); WC 368 Lease at 2 (J.A. at 67); BS 53 Lease at 1 (J.A. at 72). Two of the leases -- South Timbalier Block 107 and West Cameron Block 368 -- expressly invoke the "gross proceeds" language of the regulation, stating that the amount

of production "shall not be deemed to be less than the gross proceeds accruing to the Lessee from the sale thereof." ST 107 Lease at 2 (J.A. at 60); WC 368 Lease at 2 (J.A. at 67).

In 1989 and 1990, Century entered into production contracts with Enron Gas Marketing, Inc., under which Enron agreed to purchase gas produced from these leases. First, Enron and Century entered into "base contracts" covering an initial quantity of gas. For the purposes of this case, the base contracts had two important features: They were fixed price contracts, under which Enron agreed to purchase certain minimum quantities of gas for a fixed price; and they contained "take-or-pay" provisions. In other words, Enron was required to pay Century the price of the minimum purchase quantity, even if it did not choose to take any gas.[1] Unlike some standard take-or-pay provisions, these payments for gas not taken were non-recoupable: If Enron were to make a payment for gas not taken one month, and then take more gas than the minimum purchase quantity the next month, the excess gas would not entitle Enron to a refund of a portion of the previous month's payment. In other words, once made, Enron's payments under the take-or-pay clause were gone for good.

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[1] Enron agreed to purchase a minimum quantity of gas each month, defined as follows:

> "Minimum Purchase Quantity", for any Month during the term of this Agreement, shall mean the minimum quantity of Gas, expressed in MMBtus per day, that Buyer is obligated to purchase and receive, or pay for if available and not taken, during such Month, which quantity shall be ninety percent (90%) of the [maximum daily quantity] times the number of days in such month.

Gas Purchase Agreement, South Timbalier Block 107, at 2 (J.A. at 96).

Take-or-pay requirements provide a producer with a minimum cash flow in exchange for reserving its gas production for a purchaser. Take-or-pay requirements are a form of what economists call "demand charges": charges for reserving the option to use. In contrast, charges for the quantity of the gas used are "commodity charges." *See* John S. Lowe, *Defining the Royalty Obligation*, 49 S.M.U. L. REV. 223, 267 (1996).

The base contracts covered a certain minimum quantity of gas. At the same time, Century and Enron entered into "excess contracts" for additional gas produced from the leases in question. In contrast to the base contracts, the excess contracts provided for floating prices tied to the spot price of natural gas. They did not contain take-or-pay provisions.

In late 1991, Enron approached Century with a proposal to purchase the 1989 and 1990 contracts. On February 12, 1992, Enron and Century entered into the agreement that has given rise to the current dispute. Enron agreed to make a lump sum payment to Century of $12,250,000, in return for which Enron was relieved of its obligation to make further payments under the base contracts. At the time of the agreement, Enron did not owe Century any accrued "pay" payments under the take-or-pay clause. Century did not pay royalties to the federal government on any portion of the lump sum payment. But after receiving warnings from its bank about possible royalty liability, Century required Enron to agree to loan Century up to $1.5 million in case the government demanded royalties.

Simultaneously, Enron and Century entered into new contracts, which have become known as the "replacement contracts." These replacement contracts provided for floating prices, fixed to the spot price for natural gas. They did not provide for any minimum quantity, and lacked take-or-pay provisions. The preamble to these contracts expressly noted the parties' "desire to replace and supercede" the previous agreements. *E.g.*, Gas Purchase Contract, Breton Sound Blocks 45 and 52, at 1 (J.A. at 183). Under the replacement contracts, Enron purchased virtually all of the gas identified in the original agreements, within the same time period.

In August of 1992, Hurricane Andrew caused extensive damage to Century's platforms in the Gulf. A year later, it filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. The United States then filed a proof of claim for $1,855,004, the full royalty that would be due on production worth $12,250,000, the amount of Enron's lump

sum payment. In this adversary proceeding, the United States and Century each filed motions for summary judgment. The bankruptcy court ruled in Century's favor across the board, holding that the government's royalty claim exceeded its statutory authority, and that the government's interpretation of the gross proceeds rule was arbitrary and capricious, unlawfully retroactive, and adopted in violation of the Administrative Procedure Act's notice and comment requirement. The district court affirmed on all grounds except the last.

The government makes several arguments in support of its position that Century owes royalties on the lump sum payment. First, the government notes that courts must defer to an agency's reasonable interpretation of the statutes which it is entrusted to enforce. *See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). Within this context, it asserts that Enron made the lump sum payment to obtain a reduced price for future gas purchases. Such an advance payment for future gas, it concludes, would be analogous to an installment payment and clearly linked to the value of production under the statute. It also contends that even if the payment did not serve to obtain a reduced price, it was still "total monies and other consideration" under the government's broad interpretation of the statute and regulations.[2] As a matter of timing, the

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[2] The government contends that even if Century and Enron had not entered into the replacement contracts -- for example, if Enron had "bought out" the original contracts and walked away -- Century would owe royalties on Enron's lump sum payment as it produced (and sold to *other* pipelines or end-users) the gas identified in the original contracts. *See* Appellants' Br. at 12-13; *see also Shell Offshore, Inc.*, MMS-91 0087-OCS (Sept. 2, 1994) at 19; Letter from James W. Shaw, Associate Director for Royalty Management, MMS, to "Payor" (May 3, 1993). We emphasize, for reasons discussed below, that this is not the issue presented in the instant case, where Century and Enron continued their relationship under the replacement contracts. Thus we express no opinion on this aspect of the government's argument.

government seeks royalties on the payment as production occurs under the replacement contracts, not at the time the payment was made.

Century responds that Enron did not make the lump sum payment to reduce the price of future gas purchases. Rather, Century contends, the payment was based on "calculations of the present value of the non-recoupable take-or-pay payments that Enron would owe Century if Enron failed to purchase the minimum gas volumes required during the remaining terms" of the original contracts. Appellee's Br. at 20. Placing emphasis on the fact that Enron was not obligated to take any gas under the replacement contracts, Century characterizes the lump-sum payment as a "buy-out," unrelated for royalty purposes to the simultaneous replacement contracts. Century also contends that the Fifth Circuit's decision in *Diamond Shamrock Exploration Co. v. Hodel,* 853 F.2d 1159 (5th Cir. 1988), supports its position, and is binding on the government through the Minerals Management Service's acquiescence. Century asserts that *Diamond Shamrock* stands for the proposition that royalties are only due on payments made to purchase gas, and that this payment does not fall into that category. Century concludes that the government's current stance is arbitrary, capricious, and inconsistent with prior agency positions. Finally, Century claims that the government's interpretation of the "gross proceeds" rule is unlawfully retroactive.

II.

The government and Century both contend that their respective characterizations of the lump-sum payment flow naturally from the nature of the payment and the circumstances surrounding it. As they frame the issue, we are to determine whether the payment was a "buy-down" of the original contracts' price terms or a "buy-out" of their take-or-pay clauses. Neither characterization adequately and fully describes this payment, however. As the Louisiana Supreme Court stated in *Frey v. Amoco Production Co.,* 603 So.2d 166 (La. 1992): "Total revenue under a gas purchase contract is a

function of quantity and price. . . . Because the producer is willing to negotiate a lower price in exchange for the guarantee the pipeline will either take or pay for a specific minimum quantity of natural gas, the take-or-pay provision effectively lowers the price the producer charges the pipeline per unit of gas." *Id.* at 180. Thus, we decline to advance the fiction that some portion of this payment is clearly allocable to one purpose, and the remainder allocable to another purpose.

The termination of the 1989 and 1990 contracts and the creation of the replacement contracts are one transaction for the purposes of the instant dispute.[3] Their timing and plain language -- including the parties' stated intent to "replace and supercede" the terminated contracts -- make this interpretation the only reasonable conclusion.[4] Viewed in this light, the transaction is akin to a substituted contract, *see* RESTATEMENT (SECOND) OF CONTRACT § 279 (1979), under which Enron agreed to pay Century an advance payment for a new requirements contract. Faced *ab initio* with a simple

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[3] This conclusion stems from our interpretation of the contracts. As such, it is a matter of law subject to *de novo* review by this Court. *First Am. Bank v. Fidelity & Deposit Co.*, 5 F.3d 982, 984 (6th Cir. 1993).

[4] Century's explanation of the parties' intent is not persuasive. Century contends that the amount of the payment represented only the present value of the payments Enron would be required to pay under the take-or-pay provisions of the base contracts. Appellee's Br. at 20. Yet the depositions of employees of Century and its bank, the Bank of Montreal, fail to support this conclusion. Moreover, it is nonsensical on its face: The obligation to make such payments under the take-or-pay clause would have been contingent on Enron not taking any gas. At the very least, this sum would have to be discounted by the probability that Enron would not take any gas. In other words, the parties could not rationally have represented a contingent event in present value terms, without taking into account the likelihood of the occurrence of the contingency. Nothing in the record suggests that Enron had prospectively refused to take any gas under the contract. Indeed, we know that Enron eventually took virtually all the gas identified in the contract. Thus Century's characterization of the parties' intentions respecting the lump sum payment as unrelated to the substitute contract is unacceptable.

requirements contract, we would not examine the monthly payments required under that contract to determine the proportion of the payment allocable to contractual, risk-allocating provisions and separate it from that allocable to pure "price." Similarly, were such a requirements contract to provide for an advance payment rather than monthly payments or payment upon delivery, we would not subject the advance payment to this bifurcated analysis (though the government would not be entitled to its royalties until production). We see no reason to treat this case differently, where we hold that the lump sum payment contemplated and was the cause of new gas sales to be delivered in the future, where the parties intended a continuing relationship, and where much of the gas identified in the original contracts was delivered under the replacement contracts. The lump sum payment behaved as an advance payment under a substituted requirements contract. As a result, the payment was for "production sold" under the statute, and the royalty was payable when the gas was produced.

Diamond Shamrock. The Fifth Circuit's decision in *Diamond Shamrock Exploration Co. v. Hodel,* 853 F.2d 1159 (5th Cir. 1988) is not to the contrary. *Diamond Shamrock* addressed the royalty consequences of take-or-pay payments themselves. The Fifth Circuit applied the same statutes and regulations at issue in the instant case to payments made for gas not taken in two consolidated cases. The court noted that

> [t]he issue raised is whether payments by a pipeline-purchaser to a lessee-producer of a federal oil and gas lease pursuant to a take-or-pay clause in its gas sales contract with the pipeline-purchaser are subject to payment of a royalty when the take-or-pay payment is received, not as value for gas actually taken, but as part of the take-or-pay obligation under the contract.

Id. at 1161. The Fifth Circuit concluded that "royalty payments are not due on take-or-pay payments and are only due on gas actually produced and taken." *Id.* It based its

decision on the fact that the relevant statutes, regulations, and lease provisions all linked royalties to the value of production "saved, removed or sold" from the leased property. "The agency's regulations do not refer to 'gross proceeds' in the abstract," noted the court,

> but only to gross proceeds that accrue to the lessee from the disposition or sale of produced substances, that is, gas actually removed and delivered to the pipeline. Consequently, royalties are not owed unless and until actual production, the severance of minerals from the formation, occurs.

Id. at 1166.

As an initial matter, it is important to note that the primary *practical* consequence of *Diamond Shamrock* was the timing of royalty payments. The contracts before the court allowed the pipelines to take "make-up gas" to obtain rebates of previous take-or-pay payments. For example, consider a hypothetical pipeline that is unable to take gas one month and must make payments under a take-or-pay provision for gas not taken. The next month, it takes the contractually-specified quantity of gas and hence avoids making "pay" payments. But it is also able to take additional gas over this amount. Under the contracts at issue in *Diamond Shamrock*, it would be entitled to a year-end credit equal to the amount of the previously-made take-or-pay payments. When this credit is applied to purchases of gas, it acts as a discount, but the producer still pays royalties based on the contract (or fair market) price. Thus even under *Diamond Shamrock* the government indirectly receives royalties on the take-or-pay payments themselves, but only if and when make-up gas is actually produced and taken.

Our reading of *Diamond Shamrock* suggests that the court interpreted the relevant statutes and regulations to require some nexus with production. Under the facts of that case, that nexus was not achieved until the pipelines took make-up gas. The recoupability provisions of the contracts at issue there allowed the pipelines' take-or-pay payments to be

applied to this make-up gas. This nexus with production then triggered the leases' royalty provisions. This, we believe, is the most rational reading of the occasionally ambiguous *Diamond Shamrock* opinion. *Cf. Independent Petroleum Assoc. of America v. Babbitt*, 92 F.3d 1248, 1259 (D.C. Cir. 1996) (reading *Diamond Shamrock* to require a "link" between payments subject to royalty and the physical severance of gas).

As the above discussion makes clear, we believe the necessary nexus to production exists under the facts of the case before us. Here the simultaneous replacement contracts, under which we know virtually all the previously-identified gas was taken, provide this nexus. Though this gas was not make-up gas, it is analogous to make-up gas in the sense that though it is paid after the payment at issue, it provides a link to production. Now that this gas has been produced and delivered to Enron, royalty payments are due, not merely on the price Enron ultimately paid, but on that price plus the amount of the lump sum payment allocable to the gas ultimately taken.

Acquiescence. We are not persuaded by Century's argument that the government's response to *Diamond Shamrock* foreclosed its approach to the instant case. Because *Diamond Shamrock* is not controlling on this Court, the real issue before us is the extent to which the Minerals Management Service acquiesced in that decision by altering its regulations. After the adverse outcome in *Diamond Shamrock*, rather than appealing the decision or applying it only to those leases within the Fifth Circuit, the government amended its royalty regulations to reflect it. *See* Revision of Gross Proceeds Definition in Oil and Gas Valuation Regulations, 53 Fed. Reg. 45082 (1988). It deleted a prior inclusion of take-or-pay payments as an example in its definition of "gross proceeds," but adopted a very narrow interpretation of the *Diamond Shamrock* decision, expressly noting that the changes were "consistent with, and . . . the minimum necessitated by," the Fifth Circuit's decision. *Id.* at

45084. The ruling, the agency concluded, "requires [the Minerals Management Service] to remove the requirement to pay royalties on take-or-pay payments at the time the payment is made. Of course, royalties are still due when make-up gas is taken." *Id.* at 45083.

The government never conceded, however, that it would not seek royalties once a sufficient link to production is established. *Diamond Shamrock* makes it clear that courts should look, *ex post*, at whether certain actions create a nexus with production. In *Diamond Shamrock*, unlike the instant case, one piece of paper established recoupability and hence the necessary nexus with production. Here, we are faced with two pieces of paper, which Century characterizes as independent. But again, we are construing them together, as one transaction. Together, they provide a nexus between the lump sum payment and later production. Now that production has taken place, the government is entitled to its royalties. It is true that Enron was not absolutely obligated to take gas under the replacement contracts. But Enron did eventually take most or all of the gas. Similarly, in the recoupable take-or-pay payment situation addressed in *Diamond Shamrock*, the pipeline was not required to take make-up gas, though that action was what triggered the refunds -- and as the opinion makes clear, royalties.

As discussed above, we view this transaction, taken as a whole, as an advance payment for gas. In response to *Diamond Shamrock*, the Minerals Management Service also amended its rules for advanced payments, noting that

> [i]n view of the Fifth Circuit's ruling that royalty is not owed until make-up gas is actually produced and taken, it follows that no royalty is due on advanced payments until the specific gas which repays the advanced payment actually is produced.

Id. In the instant case, that gas has been produced, and a royalty is now due.

Finally, we note alternatively that it is difficult to see why this payment was not for production "saved" under the

language of the statute. Viewing the transaction as a whole, as economic reality requires, it seems clear that the payment was made to ensure a ready source of gas for Enron under the replacement contracts. As such, this production would be "saved" for Enron's use -- the very language used in the statute. Neither party advances this argument, however, and so we hold that the payment is royalty-bearing because, like an advanced payment, it is tightly linked to "production sold" later. Thus, we do not rest our holding on this ground.

III.

We do not find compelling the "absurd results" that the lower courts fear would result from the outcome we reach. First, the district court argues that the government's interpretation of gross proceeds "would necessitate two royalty payments for one sale of natural gas in almost every case where the producer sells natural gas after the original contract is terminated." Opinion and Order at 11 (J.A. at 49). It is true that Century would have to pay one royalty in two components. But we fail to see how this procedure presents a problem. No double-counting would result. Indeed, the *Diamond Shamrock* opinion, on which the district court otherwise relies, contemplates a similar result. Under *Diamond Shamrock*, when a purchaser receives a discount for make-up gas, the producer must still pay a royalty on the gas's contract or market value. This royalty is in essence also one royalty with two components: One based on the discounted price currently received for make-up gas, and one based on the difference between the discounted price and the market or contract price.

Second, the district court notes that "as recognized by the court in *Diamond Shamrock*, the purpose of the minimum take requirements is to apportion risk between the buyer and seller of the natural gas by compensating the producer, not the owner of the minerals, for the risks associated with development and production." *Id.* at 12 (J.A. at 50). It is true that the *Diamond Shamrock* court made this observation. However, there can be no serious contention that the

government acquiesced in this portion of the opinion. In addition, of course, this argument does not respond to the possibility that some or all of the payment was made to obtain lower future prices. Moreover, the district court's risk bearing conclusion is not persuasive. While it is true that take-or-pay provisions shift the risk of very low prices or low market liquidity to the buyer, which must make a minimum payment regardless of its ability to take the gas, the allocation of risk between the seller/lessee and the lessor is not as clear. A lessor receives diminished royalties from diminished exploration, production, and development. The mineral exploitation of its land involves the risk of opportunity costs, such as foregone profits from alternative uses of the land, that are borne solely by the lessor. *Cf. Frey v. Amoco Production Co.*, 603 So.2d 166, 178 (La. 1992) ("[I]t is a myopic eye which perceives the lessor as sharing none of the risks associated with bringing the gas to the ground...."), cited with approval in *Klein v. Jones*, 980 F.2d 521, 530 (8th Cir. 1992). A lease/royalty arrangement actually lies somewhere in the middle on the risk-allocation continuum. *Cf. Henry v. Ballard & Cordell Corp.*, 418 So.2d 1334, 1338 (La. 1982) ("Where the mineral lease provides for payment to the lessor of a fractional royalty interest, the lease arrangement is in the nature of a cooperative venture."). An outright sale -- or more realistically, a fixed-amount lease without royalties -- would have shifted more of the risks of production away from the government. Under a joint production venture, on the other hand, the government would have borne more of these risks. Thus, the district court's risk-allocation concern is not dispositive and merely begs the question at issue here. The district court's risk bearing theory is particularly unpersuasive when transferred from private parties, *see Diamond Shamrock* at 1167, to the federal government. The federal government has reasons for choosing not to act as an oil company that do not apply to private actors.

The District of Columbia Circuit's decision in *Independent Petroleum Association of America v. Babbitt*, 92 F.3d 1248 (D.C. Cir. 1996), does not compel a different

result. In *Independent Petroleum Association*, the court addressed the royalty implications of a settlement payment made to Samedan Oil Corporation, a lessee of a natural gas well on Indian lands, in exchange for a compromise of accrued and prospective take-or-pay liabilities. Samedan and the purchaser, Southern Natural Gas Company, agreed to a "complete buyout." On the same day, Samedan contracted to sell the gas that was the subject of the contract with Southern to a third party. Thus *Independent Petroleum Association* addressed a situation in which a nexus with production did not exist. *See Independent Petroleum Assoc.* at 1259-60 (construing *Diamond Shamrock* to require a "link" between royalties and physical severance). It is not at all clear how the *Independent Petroleum Association* court would have dealt with the instant case, where Enron's eventual purchase under the terms of a simultaneous replacement contract of virtually all the gas at issue provides a sufficient nexus to production to support the government's royalty claim.

Century seems to suggest that a holding in favor of the government would provide a disincentive for producers and pipelines to settle accrued take-or-pay obligations or to buy out onerous take-or-pay provisions. This contention is without merit: Our holding simply requires lessees to share these payments when they are sufficiently linked to production. Indeed, in this case, Century accepted the lump sum payment and replacement contract prices despite its own uncertainty about the royalty implications of the deal. The producer will still choose to produce, at least over the short run, because it receives a marginal gain -- it just shares it with the owner of the land. In addition, contrary to Century's contention, the prices it receives are no less "market" prices simply because they must reflect Century's obligations to its lessor.

It is important to remember that Century and other producers do not own the land that is the subject of these leases. In passing the Outer Continental Shelf Lands Act, Congress declared that "the outer Continental Shelf is a vital national

resource reserve held by the Federal Government for the public, which should be made available for expeditious and orderly development, subject to environmental safeguards, in a manner which is consistent with the maintenance of competition and other national needs." 42 U.S.C. § 1332 (1996). In opening these lands up for development, Congress created an opportunity for oil producers such as Century, but did not pull its hand away completely. The passage quoted above and the statute as a whole make it clear that the outer continental shelf is a special area in which the government retains a continuing interest. That the government chose not to simply walk away, cash in hand, from the production of resources on the outer shelf is demonstrated by these very leases, which provide for royalties linked to production rather than fixed payments. The government holds these lands "for the public'" and as such owes duties to all its citizens. This includes consumers and those who navigate, fish, and enjoy the beauty of the lands, not solely those who help the government exploit the lands' resources. *Cf.* William H. White, *The Right to Recover Royalties on Natural Gas Take-or-Pay Settlements,* 41 OKLA. L. REV. 663, 674 (1988) (acknowledging the argument that "[t]ake-or-pay receipts are created by the lease and the productive capacity of the property. The lessee would have no basis to obtain take-or-pay benefits but for the lease.").

IV.

Retroactivity. Century claims that the government's demand for royalties is unlawfully retroactive. The lower courts both agreed with Century on this independent ground. Century argues that the government announced and applied its current approach to royalties for contract settlements in two administrative cases imposing royalty obligations on settlements of take-or-pay obligations or contractual provisions, *Shell Offshore, Inc.*, MMS-91-0087-OCS (Sept. 2, 1994) and *Samedan Oil Corp.* MMS-94-0003-IND (Sept. 16, 1994). Because this approach was a departure from settled practice at the time, concludes Century, it should not apply to

the lump sum payment in the instant case, which occurred in early 1992. We disagree.

In *Sun Exploration and Production Co.*, 112 I.B.L.A. 373 (1990), the Interior Board of Land Appeals restricted the ability of the Minerals Management Service to depart from a previous administrative position and apply a new approach retroactively. The threshold question is whether the Minerals Management Service's construction of the gross proceeds rule in these cases was "an abrupt departure from a well-established practice," in which case retroactive application is restricted, or merely "an attempt to fill a void in an unsettled area of the law." *Id.* at 392.

In support of its argument that *Shell Offshore* and *Samedan* represented departures from established practice, Century points to the fact that the Minerals Management Service amended its royalty provisions in response to the *Diamond Shamrock* opinion, and asserts that during the following five years the Service "consistently and repeatedly disclaimed royalties on non-recoupable settlement payments." Appellee's Br. at 45. In response, the government claims that the Department of the Interior had made no "final" or "definitive" pronouncement on the subject. Appellant's Br. at 47.

We hold that the government's decision to seek royalties in this case, and its decisions in *Shell Offshore* and *Samedan*, were not abrupt departures from well-established practice. The contrary agency positions cited by Century are not applicable to these facts. For example, Century refers to an internal memorandum dated November 30, 1990, in which a Minerals Management Service official considered a possible refund of royalties paid by Chevron, U.S.A. after Chevron received a "buy-out" payment from a gas purchaser. Letter from Milton K. Dial, Chief of Royalty Valuation and Standards Division, MMS, to Chief of Fiscal Accounting Division, MMS (Nov. 30, 1990). The memorandum states that "contract 'buy-out' payments received by a producer to free a purchaser from future obligations under a sales contract are not associated with production removed from the lease and, therefore, will not be

subject to royalty." *Id.* Century asserts that it had a right to rely on this language when it participated in the transactions at issue in the instant case.

But, as outlined above, this case involves more than a purchaser buying out a contract and walking away from the relationship. Here, the contemporaneous replacement contracts make this transaction more akin to a buy-down, notwithstanding the parties' characterization. The Chief of Royalty Valuation's memo makes clear that buy-downs and buy-outs are to be treated differently. His memo defines a buy-out payment as one "not associated with production removed from the lease." *Id.* In contrast, we have held here that by taking the same gas under the replacement contracts, Enron provided a sufficient association with production.[5] In addition, as noted above, we believe *Diamond Shamrock* implies this conclusion. Thus we hold that at the very least the government's position here and in *Shell Offshore* and *Samedan* is merely "an attempt to fill a void in an unsettled area of the law."

V.

Notice and comment requirement of the Administrative Procedure Act. On this issue the district court overturned the ruling of the bankruptcy court. We agree with the district court's holding that the government's issuance of *Shell Offshore* did not violate the notice and comment requirement of the Administrative Procedure Act, 5 U.S.C. § 553(b) (1996). Though an agency is ordinarily required to provide notice and an opportunity for comment before adopting a new rule, *id.*, notice and comment are not necessary when the agency issues "interpretive rules." *Shalala v. Guernsey Memorial Hospital,* 115 S. Ct. 1232, 1239 (1995). An

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[5] Notably, the memorandum also cautioned that the circumstances leading to a contract 'buy-out' payment and the agreements under which it is made must be reviewed to ensure that payment is tendered only in consideration of the contract termination." *Id.*

interpretive rule is one "issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers." *Id.* We agree with the district court that *Shell Offshore* "advises the public of the DOI's construction of OCSLA and the gross proceeds rule as applied to contract settlement payments," and hence that notice and comment were not required. In addition, in light of our holding that the government's approach to royalties here and in *Shell Offshore* is not an abrupt departure from well-established practice, we doubt that it is a new rule in any case.

CONCLUSION

For the foregoing reasons, we disagree with the district court's conclusion that the government is not entitled to a royalty on the portion of the lump sum payment allocable to gas produced under the replacement contracts. We agree that the government's actions did not violate the Administrative Procedure Act. Accordingly, the district court's judgment is REVERSED in part and AFFIRMED in part, and the case is REMANDED to the district court, which should determine the royalty due in accordance with this opinion.

No. 95-6320

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

FILED
JUL 23 1997
LEONARD GREEN, Clerk

IN RE: CENTURY OFFSHORE MANAGEMENT CORPORATION,

Debtor,

UNITED STATES OF AMERICA,

Plaintiff-Appellants,

v.

CENTURY OFFSHORE-MANAGEMENT CORPORATION,

Defendant-Appellee.

ORDER

BEFORE: MERRITT, JONES, and COLE, Circuit Judges.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT
/s/ Leonard Green
Leonard Green, Clerk

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
LEXINGTON

CIVIL ACTION NO. 95-116

Eastern District of Kentucky
FILED: AUG 4, 1995
AT LEXINGTON
LESLIE G. WHITMER
CLERK: U.S. DISTRICT COURT

IN RE: CENTURY OFFSHORE MANAGEMENT CORP.
BANKRUPTCY CASE NO. 93-5-1340

Debtor.

UNITED STATES OF AMERICA,

Appellant,

v.

CENTURY OFFSHORE MANAGEMENT CORPORATION,

Appellee.

OPINION AND ORDER

* * * * * * * * * * * * * * *

The United States of America, on behalf of the U.S. Department of the Interior, Bureau of Minerals Management Service ("MMS"), seeks to appeal the bankruptcy court's order of February 13, 1995, granting the motion of the appellee, Century Offshore Management Corporation ("Century"), for summary judgment and denying the United States' cross-motion for summary judgment.

I. FACTS AND PROCEDURAL BACKGROUND

Prior to filing for bankruptcy under Chapter 11 of the United States Bankruptcy Code on August 23, 1993, Century entered into several oil and gas leases issued by MMS

pursuant to the Outer Continental Shelf Lands Act ("OCSLA"), 43 U.S.C. § 1331, *et seq.*, and the regulations promulgated thereunder. The leases are located in offshore federal waters adjacent to Louisiana on the Outer Continental Shelf ("OCS") in the Gulf of Mexico. Among the OCS leases held by Century are the leases commonly known as the South Timbalier Block 107 Lease ("ST 107"), the West Cameron Block 368 Lease ("WC 368"), and the Breton Sound Block 53 Lease ("BS 53"). Century also entered into leases of two offshore blocks leased by the State of Louisiana, commonly known as the Breton Sound Block 52 Lease ("BS 52") and the Breton Sound Block 45 Lease ("BS 45"). Under the OCSLA, the United States is entitled to receive a royalty payment from the federal lessees equal to a fixed percentage of the amount or value of the production saved, removed or sold.

In 1989 and 1990, Century and Enron Gas Marketing, Inc. ("Enron") entered into several gas purchase contracts under which Enron agreed to purchase certain minimum quantities of natural gas produced by Century from the ST 107 Lease, the WC 368 Lease, and the BS 53 Lease. Under the Gas Purchase Agreement executed on December 20, 1989 (the "ST 107 Base Contract"), Enron agreed to purchase a certain minimum quantity of natural gas each month that could not be less that the "Minimum Purchase Quantity" as defined in Section 1.1 of the ST 107 Base Contract, which provides:

> "Minimum Purchase Quantity", for any month during the term of this Agreement, shall mean the minimum quantity of Gas, expressed in MMBtu per day, that Buyer is obligated to purchase and receive, or pay if available and not taken, during the month, which quantity shall be ninety percent (90%) of the MDQ [Maximum Daily Quantity] times the number of days in such month.

If Enron failed to purchase that minimum quantity of natural gas in any month, Enron was required to make non-recoupable payments to Century, pursuant to Section 3.4 of

the ST 107 Base Contract ("take-or-pay payments"). The ST 107 Base Contract, originally effective through March 31, 1996, was subsequently extended through October 31, 1996.

Similarly, under the Gas Purchase Agreement executed on March 27, 1990 (the "WC 368 Base Contract"), Enron agreed to purchase certain minimum quantities of natural gas produced by Century from the WC 368 Lease, the BS 45 Lease, and the BS 52 Lease on a monthly basis. Under Section 3.4 of the WC 368 Base Contract, Enron also agreed to make non-recoupable take-or-pay payments to Century in any month in which Enron failed to purchase that minimum quantity of natural gas. The term of the WC 368 Base Contract extended through September 30, 1995.

Due to a decline in the market price for gas, Enron informed Century in November 1991 that it wished to purchase the natural gas contracts between Century and Enron covering the ST 107, WC 368, and BS 53 leases. Century and Enron each prepared calculations of the present value of the payments that Enron would be required to make under the contracts during their remaining terms if Enron failed to purchase the minimum quantities of natural gas required by the ST 107 and WC 368 Base Contracts and instead paid Century the non-recoupable payments required by Section 3.4 of the ST 107 and WC 368 Base Contracts for failure to make those purchases. As a result of their calculations and negotiations, Century and Enron entered into a settlement agreement on February 12, 1992, whereby Enron made a lump sum, non-recoupable payment to Century of $12,250,000.00 and Enron was relieved of any obligation to make any further payments under the ST 107 and WC 368 Base Contracts as of January 1, 1992 (the "Enron settlement"). Century did not pay royalties to the federal government on any portion of that lump sum payment.

On February 11, 1994, the MMS filed a proof of claim alleging that it is the holder of an unsecured priority claim in the amount of $1,855,004.00 as oil and gas royalties on the Enron settlement. In support of its claim, the MMS alleges

that as a result of Century's receipt of the lump sum payment from Enron, and by failing to pay its alleged royalty obligation, Century breached its lease agreement with the MMS. Century filed its objections to the MMS' proof of claim on May 13, 1994, denying that any mineral royalties are due.

On December 16, 1994, Century filed a motion for summary judgment seeking disallowance of the MMS' proof of claim, arguing that the MMS is not entitled to royalties on a contract settlement payment that Enron made to Century in order to terminate Enron's future obligations under the gas purchase contracts with Century. On January 17, 1995, the United States filed an opposition to Century's motion for summary judgment, and also filed a cross-motion for summary judgment seeking allowance of the MMS' proof of claim in the amount of $1,004,422.70, plus additional royalty payments of unspecified amounts which are allegedly due through September 30, 1995.

At a hearing held on January 20, 1995, the bankruptcy court ruled from the bench to sustain Century's motion for summary judgment and to overrule the United States' cross-motion for summary judgment. Thereafter, on February 13, 1995, the bankruptcy court entered a final judgment in favor of Century and issued a written opinion with findings of fact and conclusions of law. The United States filed its notice of appeal of January 27, 1995.

II. THE BANKRUPTCY COURT'S ORDER

The bankruptcy court based its decision to grant Century's motion for summary judgment on several grounds. First, the bankruptcy court considered the statutory, regulatory, and contractual authority upon which the MMS based its royalty claim. The bankruptcy court adopted the Fifth Circuit Court of Appeal's interpretation of the term "value of production" in *Diamond Shamrock Exploration Corp. v. Hodel*, 853 F.2d 1159, 1168 (5th Cir. 1988) and determined that under Section 8(a) of OCSLA, the regulations promulgated thereunder, and the OCS leases themselves,

royalties are due on OCS leases only when there has been actual production, "meaning the severance of the minerals from the producing underground formation."

Applying that analysis to the present case, the bankruptcy court held that Enron's payment of $12,250,000.00 to Century was to terminate Enron's future obligations under the ST 107 and WC 368 Base Contracts to make non-recoupable payments to Century when Enron failed to purchase certain minimum quantities of natural gas, not for the severance of natural gas. In other words, the payment was "not a price paid for either present or future deliveries of severed hydrocarbons to Enron." Consequently, the bankruptcy court held that, under OCSLA, the regulations promulgated thereunder, and the OCS leases, Enron's settlement payment to Century is not royalty bearing. Because the MMS' royalty claim is based on an interpretation of gross proceeds which exceeds its statutory, regulatory, and contractual authority, the bankruptcy court granted Century's motion for summary judgment and denied the United States' cross-motion for summary judgment.

The bankruptcy court further determined that the MMS' royalty claim is based on an interpretation of "gross proceeds" that is arbitrary and capricious. Specifically, the bankruptcy court determined that allowing the MMS' royalty claim would require the lessee to make two royalty payments on one sale, would provide a windfall benefit to the government, would unfairly deprive producers of admitted royalty overpayments, and would distort the concept of "fair market value" on which the royalty regulations are based.

Next, the bankrupt court held that the MMS' interpretation of "gross proceeds" on which it relies was not adopted in compliance with the rulemaking requirements of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553. According to the bankruptcy court, the royalty values, as set out in *Shell Offshore, Inc.*, Docket No. MMS-91-0171-OCS, must be rejected for failure to comply with the notice and comment provision of the APA.

Finally, the bankruptcy court determined that MMS' new interpretation of "gross proceeds" should not be given retroactive effect based on the criteria established by the Department of Interior in *Sun Exploration and Production Co.*, 112 IBLA 373 (1990), in which the Interior Board of Land Appeals sharply limited the circumstances in which MMS may apply a new interpretation of a regulation retroactively. Based on *Sun Exploration*, the bankruptcy court concluded that even if the MMS' interpretation is otherwise lawful, the MMS' interpretation is unlawfully retroactive.

III. ISSUES FOR REVIEW

The United States has presented two issues for appeal:

1. Whether the bankruptcy court erred in sustaining Century's motion for summary judgment?

2. Whether the bankruptcy court erred in denying the United States' cross-motion for summary judgment?

IV. STANDARD FOR REVEW

Rule 56 of the Federal Rules of Civil Procedure applies in adversary proceedings. Fed. R. Bankr. P. 7056. Pursuant to Rule 56, summary judgment is appropriate if the moving party establishes that there is no genuine issue of material fact for trial and that it is entitled to judgment as a matter of law. *See Celotex Corp. v. Catrett*, 477 U.S. 317 (1986). The Court must consider all pleadings, depositions, affidavits, and admissions on file and draw reasonable inferences in favor of the party opposing the motion. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *see Smith v. Hudson*, 600 F.2d 60 (6th Cir.), *cert. dismissed*, 444 U.S. 986 (1979).

Once the moving party shows that there is an absence of evidence to support the nonmoving party's case, the nonmoving party has the burden of coming forward with evidence raising a triable issue of fact. *Celotex Corp.*, 477 U.S. at 324. To sustain this burden, it may not rest on the mere allegations of its pleadings. Instead, it must set forth

specific facts showing that there is a genuine issue for trial. *Potter's Med. Center v. City Hosp. Ass'n.*, 800 F.2d 568 (6th Cir. 1986). Ultimately, the standard for determining whether summary judgment is appropriate is "whether the evidence presents a sufficient disagreement to require submission to a jury or whether it is so one-sided that one party must prevail as a matter of law." *Booker v. Brown & Williamson Tobacco Co.*, 879 F.2d 1304, 1310 (6th Cir. 1989) (quoting *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 251-52 (1986)).

Review of an order of the bankruptcy court granting summary judgment is *de novo. See, e.g., Berlin v. Michigan Bell Tel. Co.*, 858 F.2d 1154, 1161 (6th Cir. 1988). Based on a *de novo* review of the record and applying the Rule 56 standards, the Court determines that the bankruptcy court was correct as a matter of fact and law in granting Century's motion for summary judgment and denying the United States' motion for summary judgment.

V. THE BANKRUPTCY COURT DID NOT ERR IN GRANTING CENTURY'S MOTION FOR SUMMARY JUDGMENT

A. THE ROYALTY CLAIM EXCEEDS THE MMS' STATUTORY, REGULATORY, AND CONTRACTUAL AUTHORITY

The bankruptcy court correctly concluded that the MMS' royalty claim exceeds the statutory, regulatory, and contractual authority of the MMS. Section 8(a) of OCSLA provides that the United States is entitled to a royalty based on a percentage of the "amount or value of the production saved, removed, or sold" from the leased premises. 43 U.S.C. § 1337(a). Pursuant to OCSLA, the Department of the Interior ("DOI") has promulgated regulations, which interpret Section 8(a). Specifically, 30 C.F.R. § 206.152(h) -- the "gross proceeds rule"-- provides:

> Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing

> to the lessee for lease production, less applicable allowances determined pursuant to this subpart.

The royalty provisions of the ST 107, WC 368. and BS 53 leases essentially track the language of Section 8(a) and the gross proceeds rule. Section 6(b) of the OCS Leases including the leases at issue in this proceeding, provides in relevant part:

> [T]he value of production for the purposes of computing royalty shall not be deemed to be less than the gross proceeds accruing to the Lessee from the sale thereof.

Construing the term "value of production," the Fifth Circuit Court of Appeals in *Diamond Shamrock Exploration Corp. v. Hodel*, 853 F.2d 1159, 1168 (5th Cir. 1988), determined that production is defined as the actual physical severance of the mineral from the formation.

Under the ST 107 and WC 368 Base Contracts, Enron agreed to purchase certain minimum quantities of gas from Century each month; failure to purchase that minimum quantity resulted in Enron's obligation to make non-recoupable payments to Century. While negotiating the settlement agreement, Enron and Century calculated the non-recoupable payments that Enron would have made to Century during the period of the Base Contracts in the event that Enron failed to purchase the minimum monthly quantities of gas as required by the Base Contracts. Based on these calculations, Enron and Century agreed that Enron would pay $12,250,000.00 to Century. In return, Century would extinguish Enron's future obligations under the Base Contracts.

Although the bankruptcy court determined that Enron's settlement payment was not for natural gas but rather to terminate the gas purchase contracts, the MMS argues that it is "permissible" under the gross proceeds rule for the government to treat Enron's settlement payment as a prepayment to purchase natural gas in the future from the covered leases. Consequently, the MMS argues that the Court should defer to the government's interpretation of the gross

proceeds rule pursuant to the rules of statutory construction set out by the Supreme Court in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). According to *Chevron*, when a court reviews an agency's interpretation of a statute authorizing administration of the agency's programs, the "question for the court is whether the agency's answer is based on a permissible construction of the statute."

The MMS relies on its interpretation of the gross proceeds rule as set forth in *Shell Offshore, Inc.*, Docket No. MMS-91-0171-OCS (September 2, 1994) and *Samedan Oil Corp.*, Docket No. MMS-94-0003-IND (September 16, 1994). In *Shell Offshore*, the Assistant Secretary ruled that payments under contract settlements are royalty bearing if and when there is production of the gas to which the payments are attributable. However, if no gas is produced, the lessee does not owe royalties to the government. In *Samedan*, the lessee, Samedan Oil Corporation ("Samedan"), appealed the decision of the MMS which assessed $20,000.00 in royalties against Samedan to the Assistant Secretary for the DOI. Samedan and Southern Natural Gas ("Southern") entered into a gas purchase contract in 1981 which contained take-or-pay provisions which required Southern to pay for a minimum quantity of gas each year, even if it did not take that amount. However, to the extent that Southern purchased gas in excess of the specified minimum in a given year, it could credit payments for gas not taken over the five preceding years against the purchase of an equivalent quantity of the current year's excess. As a result of the decline in both the sales and market price of natural gas, Samedan and Southern entered into a settlement agreement on December 1, 1987 whereby Southern was released from all past and future obligations under the 1981 contract and Southern paid Samedan $100,000.00.

On December 2, 1987, the MMS issued an order requiring Samedan to pay $20,000.00 in royalties based on the settlement. This order was appealed to the Assistant

Secretary of the DOI. In an opinion affirming the MMS' decision, the Assistant Secretary held that Southern's buyout payment was subject to a royalty when production of the bought out volumes occurred and the gas was sold to subsequent purchasers at a discounted price.

The MMS argues that this Court should defer to its interpretation of "gross proceeds," as set out in *Shell Offshore* and *Samedan*, and require that Century pay a royalty to the government on Enron's payment that was made in compromise of non-recoupable take-or-pay payments. As pointed out by the bankruptcy courts however, there is no need or obligation for this Court to defer to an agency decision when a court has already issued a definitive interpretation of the statute, the implementing regulations, and the relevant contract provisions. *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 998 F.2d 1295 (5th Cir. 1993). Not only has the court *in Diamond Shamrock* interpreted Section 8(a) of OCSLA and the gross proceeds rule contained in the regulations, but the MMS has amended the royalty regulations to conform to that interpretation. Therefore, it is not necessary for the Court to defer to the agency's interpretation of "gross proceeds" as set forth in *Shell Offshore* and *Samedan.*

Even if deference was appropriate, the Court would be required to reject the MMS' interpretation of "gross proceeds" as impermissible. Enron's payment to Century was not for present or future deliveries of severed natural gas to Enron; rather it was to terminate Enron's future obligations under the ST 107 and WC 368 Base Contracts. According to Section 8(a) of OCSLA and the gross proceeds rule, as well as the language contained in the royalty provisions of the OCS leases, royalties are due only where there has been production, meaning the severance of minerals from the producing underground formation. A royalty is not due on a take-or-pay payment because that payment was not made for severed gas but rather because the purchaser failed to purchase gas. *Diamond Shamrocks*, 853 F.2d at 1167-68. By

interpreting "gross proceeds" to include payments made not for natural gas but rather to terminate a contractual obligation, the MMS exceeded its statutory, regulatory, and contractual authority and, therefore, the MMS' interpretation of "gross proceeds" is impermissible. As no genuine issue of material fact exists on this issue, the bankruptcy court correctly granted Century's motion for summary judgment and denied the United States' cross-motion for summary judgment.

B. THE ROYALTY CLAIM IS BASED ON AN INTERPRETATION OF THE GROSS PROCEEDS RULE THAT IS ARBITRARY AND CAPRICIOUS

The bankruptcy court also determined that the MMS' royalty claim is based on an interpretation of the gross proceeds rule that is arbitrary and capricious. This court agrees with the bankruptcy court for several reasons. First, the MMS' interpretation of gross proceeds would necessitate two royalty payments for one sale of natural gas in almost every case where the producer sells natural gas after the original contract is terminated. *See Diamond Shamrock*, 853 F.2d at 1166. Not only would the producer be required to pay one royalty based on the proceeds received for the sale of natural gas under a successor contract, but the producer must also pay a second royalty on the same sale based on the portion of the settlement payment which the MMS allocates to that sale.

Second, as recognized by the court in *Diamond Shamrock*, the purpose of the minimum take requirements is to apportion risk between the buyer and seller of the natural gas by compensating the producer, not the owner of the minerals, for the risks associated with development and production. *Id.* at 1167. According to *Diamond Shamrock*:

> [T]his is the precise reason for entering into a lease agreement. The government leases oil producing lands in order to, among other things, reap the benefits, through royalty payments, without having to shoulder the

> associated risks of exploration, production and development.

Id. It would be irrational to let the government share in any revenues that the producer realized by taking those market risks while simultaneously protecting the government from any and all losses suffered by the producer as a result of taking those same risks.

Third, the court in *Diamond Shamrock* also determined that the position put forth by the MMS could in some cases unfairly deprive producers of refunds of admitted royalty overpayments, resulting in a windfall to the government. *Id* at 1166. Under OCSLA, a producer only has two years in which to seek a royalty refund of a royalty overpayment made on a federal offshore lessee. 43 U.S.C. § 1339. On the other hand, the government claims to have broad discretion to reallocate a settlement payment among the various issues settled and/or among the various leases covered by the settlement. Thus, the government may delay challenges of this type until after the two year time limit on refunds has expired. Consequently, in many instances, producers could lose the right to a refund of an admitted royalty overpayment merely because of the government's lack of diligence in pursuing this type of claim.

Finally, the MMS' interpretation of "gross proceeds" distorts the concept of "fair market value" on which the government's royalty regulations are based. According to the MMS, a payment made to terminate future obligations under a gas purchase contract is part of the "market value" of natural gas that will be produced and sold at a later time to the same or a different purchaser. But if the purchaser does not take gas under the original gas purchase contract, there is no market for that gas. Thus, it is nonsensical to claim that any portion of the settlement payment is part of the "fair market value" of gas sold at a later time under a different contract.

The government's claim in this case is based on an interpretation of "gross proceeds" which produces the same unsound and untenable results which troubled the court in *Diamond Shamrock*. Thus, the bankruptcy court correctly

determined that the MMS' royalty claim is based on an interpretation of "gross proceeds" which is arbitrary and capricious.

C. THE ROYALTY CLAIM IS UNLAWFULLY RETROACTIVE

The bankruptcy court further determined that the MMS' royalty claim is based on an interpretation of "gross proceeds" that is unlawfully retroactive under the criteria established by the MMS in *Sun Exploration and Production Co.*, 112 IBLA 373 (1990). The interpretation upon which the MMS relies was issued in *Shell Offshore* more than two years after the settlement between Century and Enron and more than seven months after the MMS filed its royalty claims in this case

In *Sun Exploration*, the Interior Board of Land Appeals ("IBLA") sharply limited the circumstances in which the MMS may apply a new interpretation of a regulation retroactively. Specifically, the IBLA held that when the MMS departs from a prior administrative position and seeks to apply a new position retroactively, it is not enough for the agency to demonstrate that its new interpretation is within the meaning of the law. *Id.* at 387. Rather, the IBLA held that the burden of clearly setting forth and identifying its change in sufficient detail to show that the departure from the prior position was not arbitrary and capricious. *Id.* at 387-88. Furthermore, the MMS must satisfy the balancing test set out in *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 390 (D.C. Cir. 1972), which requires the court to determine:

> (1) whether the case is one of first impression; (2) whether the new rule is an abrupt departure from well-established practice or merely an attempt to fill an unsettled area of law; (3) the extent to which the party against whom the new rule is applied relied on the old rule; (4) the burden which a retroactive order imposes on that party; and (5) the statutory interest in applying a new rule retroactively.

This Court agrees with the bankruptcy court that the MMS did not even attempt to satisfy its burden of proving that its interpretation of "gross proceeds" should be made retroactive under the criteria established in *Sun Exploration*. Therefore, the bankruptcy court correctly determined that the interpretation upon which MMS' royalty claim is based cannot be applied retroactively to this action.

E. *IPAA V. BABBITT* IS NOT BINDING ON THIS COURT

In *Independent Petroleum Association of America v. Babbitt*, __ F.3d__ (D.C. 1995), which affirmed the Assistant Secretary's decision in *Samedan, supra*, the district court considered whether the government was entitled to royalties on gas settlement contract entered into between Samedan and Southern. The district court determined that the MMS' order to pay royalties is in accordance with the law and is a permissible construction of the agency's rules and regulations and affirmed the Assistant Secretary's decision requiring Samedan to pay $20,000.00 in royalties to the United States.

Although the Court has reviewed and considered the decision of the court in *IPAA v. Babbitt*, that opinion is not binding on this Court. Moreover, the IPAA recently filed a notice appealing the decision in that case to the United States Court of Appeals for the District of Columbia Circuit.

F. THE BANKRUPTCY COURT ERRED IN HOLDING THAT THE ROYALTY CLAIM IS BASED ON AN INTERPRETATION OF THE GROSS PROCEEDS RULE THAT WAS ADOPTED IN VIOLATION OF THE APA'S NOTICE AND COMMENT REQUIREMENT

Although the bankruptcy court correctly determined that the MMS' royalty claim exceeds the MMS' statutory, regulatory, and contractual authority, is arbitrary and capricious, and is unlawfully retroactive, the bankruptcy court erred when it held that the MMS' royalty claim was based on an interpretation of the gross proceeds rule that was adopted

in violation of the APA. The bankruptcy court held that the Assistant Secretary of the DOI, in issuing *Shell Offshore*, failed to comply with the rulemaking requirements of the APA. Generally, the APA requires notice and an opportunity for comment before a rule can be implemented. 5 U.S.C. § 553(b). However, in *Shalala v. Guernsey Memorial Hospital*, 115 S. Ct. 1232 (1995), the Supreme Court recently held that notice and comment are not required under the APA when an agency issues an interpretative rule. An "interpretative rule" is defined as a rule "issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers." *Id.* at 1238. Because the decision in *Shell Offshore* advises the public of the DOI's construction of OCSLA and the gross proceeds rule as applied to contract settlement payments, it is an interpretative rule and the APA's notice and comment requirements are not required. Consequently, the bankruptcy court erred in concluding that the Assistant Secretary's decision in *Shell Offshore* failed to comply with the APA's notice and comment requirements. This error, however, does not affect the other grounds on which the bankruptcy court granted Century's motion for summary judgment.

VI. THE BANKRUPTCY COURT DID NOT ERR IN DENYING THE UNITED STATES' CROSS-MOTION FOR SUMMARY JUDGMENT

For the foregoing reasons, the bankruptcy court did not err in granting Century's motion for summary judgment and denying the United States' cross-motion for summary judgment.

VII. CONCLUSION

For the foregoing reasons, the bankruptcy court correctly granted Century's motion for summary judgment and denied the United States' cross-motion for summary judgment.

Accordingly, the Court hereby ORDERS:

(1) the motion for oral argument [docket entry 8] is DENIED;

(2) the bankruptcy count's order of February 13, 1995 is AFFIRMED; and

(3) this matter is STRICKEN from the active docket.

This 4th day of August 1995.

/s/ Karl S. Forester
KARL S. FORESTER,
JUDGE

NOTICE IS HEREBY GIVEN OF THE
ENTRY OF THIS ORDER OF JUDGEMENT
ON 8/4/95
LESLIE G. WHITMER, CLERK
BY: /s/ Larry G. Brown D.C.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF KENTUCKY
LEXINGTON DIVISION

CASE NO. 93-51340
CHAPTER 11

EASTERN DISTRICT OF KENTUCKY
FILED
FEB 13 1995
AT LEXINGTON
BETTY L. JENNETTE, CLERK
U.S. BANKRUPTCY COURT

IN RE: CENTURY OFFSHORE MANAGEMENT CORPORATION,

Debtor.

FINDING OF FACT AND CONCLUSIONS OF LAW

Pursuant to Rule 7056, Federal Rules of Bankruptcy Procedure which incorporates Rule 56, Federal Rules of Civil Procedure, the Court enters these findings of fact and conclusions of law based on the pleadings and evidence submitted by the parties. Oral argument was heard by the Court on January 20, 1995.

PROCEDURAL BACKGROUND

1. On August 23, 1993, Century Offshore Management Corporation ("Debtor" or "Century") filed a petition for relief under Chapter 11 of the United States Bankruptcy Code

2. On February 11, 1994, the United States of America filed two proofs of claim on behalf of the Minerals Management Service ("MMS") of the United States Department of Interior ("DOI"). Only one claim is presently in dispute. The disputed claim is a claim for additional oil and gas royalties in the amount of $1,855,004 00 ("Royalty

Claim"). In connection with the Royalty Claim, the MMS alleges that, as a result of the Debtor's receipt of a lump sum payment from Enron Gas Marketing ("Enron"), Century owes a royalty payment to the MMS, and, by failing to pay such alleged royalty obligation, has breached its lease agreement with the MMS.

3. On May 13, 1994, the Debtor filed its objection to the MMS Royalty Claim.

4. On or about May 19, 1994, the MMS filed a motion to withdraw the reference with respect to the MMS Royalty Claim and the Debtor's objection to the claim.

5. On October 25, 1994, the United States District Court denied the MMS' motion.

6. On December 16, 1994, Century filed a motion for summary judgment determining that, based on undisputed facts and as a matter of law, the MMS is not entitled to royalties on a contract settlement payment that Enron made to Century in order to terminate Enron's obligations under certain gas purchase contracts with Century.

7. On January 16, 1995, the MMS filed an opposition to Century's motion as well as a cross-motion for summary judgment determining that royalties of $1,004,422.70 are currently due on the contract settlement payment that Century received from Enron. In its motion, the government also claims that additional royalty payments of unspecified amounts may be due to the government at unspecified times during the period ending September 30, 1995.

8. On January 20, 1995, the Court held a hearing on the motion for summary judgment filed by Century.

FINDINGS OF FACT

1. Debtor Century is a corporation organized under the laws of the State of Kentucky.

2. Century produces natural gas from various leases of oil and gas underlying submerged federal lands on the Outer Continental Shelf offshore the State of Louisiana.

3. During April 1987, Century acquired a working interest in a lease of oil and gas underlying federal submerged lands on the Outer Continental Shelf commonly known as the West Cameron Block 368 Lease ("WC 368 Lease").

4. During June 1989, Century acquired a working interest in a lease of oil and gas underlying federal submerged lands on the Outer Continental Shelf commonly known as the South Timbalier Block 107 Lease ("ST 107 Lease").

5. During April 1990, Century acquired a working interest in a lease of oil and gas underlying federal submerged lands on the Outer Continental Shelf commonly known as the Breton Sound Block 53 Lease ("BS 53 lease").

6. On December 20, 1989, Century and Enron entered into a contract under which Enron agreed to purchase natural gas that Century produced from the ST 107 Lease ("ST 107 Base Contract").

7. On March 23, 1990, Century and Enron entered into a contract under which Enron agreed to purchase natural gas that Century produced from the WC 368 and BS 53 Leases ("WC 368 Base Contract").

8. In addition to the base contracts described above, Century and Enron entered into several other gas purchase contracts covering these fields. Under those contracts, Enron had the right, under certain circumstances, to purchase additional quantities of gas from these fields at agreed prices.

9. During November 1991, Enron informed Century that Enron wished to purchase the natural gas contracts between Century and Enron covering the ST 107, WC 368, and BS 53 Leases. During negotiations on that matter, Enron presented Century with a calculation of the present value of the payments that Enron would be required to make under the contracts during their remaining terms if Enron failed to purchase the minimum quantities of gas required by those agreements and instead paid Century the non-recoupable payments required for failure to make those purchases. Century presented Enron with a similar calculation.

10. On the basis of negotiations concerning those calculations, on February 12, 1992, the parties entered into a "Termination of Gas Purchase Agreements." Under that agreement, Enron made a lump sum, non-recoupable payment to Century of $12, 250, 000. Century has not paid royalties to the federal government on any portion of that lump sum payment.

CONCLUSIONS OF LAW

1. The objection to claim and the summary judgment action filed by Century are core proceedings pursuant to 28 U.S.C. § 157(b)(2)(8) and are also governed by Rule 9014, Federal Rules of Bankruptcy Procedure. The Court has jurisdiction pursuant to 28 U.S.C. § 1334(b).

2. The ST 107, WC 368, and BS 53 Leases were issued under Section 8 of the Outer Continental Shelf Lands Act of 1953 ("OCSLA"), 43 U.S.C. §1337. Under Section 8(a) of OCSLA, the federal government is entitled to a royalty based on a percentage of the "amount or value of the production saved, removed, or sold" from the leased premises. 43 U.S.C. §1337(a). Identical language is contained in the royalty clause of the ST 107, WC 368, and BS 53 Leases.

3. Under the "gross proceeds" rule, the "value of production" for royalty purposes cannot be less than the gross proceeds "accruing to the lessee for lease production . . ." 30 C.F.R. § 206.152(h) (1993).

4. In *Diamond Shamrock Exploration Corp. v. Hodel,* 853 F.2d 1159 (5th Cir. 1988), the United States Court of Appeals for the Fifth Circuit construed and applied the federal law applicable to oil and gas leases located on the Outer Continental Shelf. In that opinion the appellate court considered the proper interpretation of the term "value of production" in Section 8(a) of OCSLA, which, as noted above, is also used in the "gross proceeds" rule as well as the federal offshore leases in this case.

5. As construed in *Diamond Shamrock*, for royalty purposes, "production" means the actual physical severance of the minerals from the formation:

> In the interests of consistency, logic and economics, this court adopts as the legal definition of the word "production," as used in the context of calculating royalty payments, the actual physical severance of minerals from the formation. For purposes of royalty calculation and payment, production does not occur until the minerals are physically severed from the earth.

Id. At 1168 (footnote omitted). The Fifth Circuit noted that this definition of "production" was "consistent with, and, indeed, identical to," definitions adopted by numerous other courts including the United States Supreme Court; the United States Court of Appeals for the Ninth Circuit; the United States Court of Appeals for the Tenth Circuit; and courts in the States of Louisiana, Montana, Texas, and Wyoming. *Id.* at 1168 n. 39. *See also Associated Gas Distributors v. FERC*, 893 F.2d 349 at 359 (D.C. Cir. 1989) (unrecoupable buyout and buydown settlements are not payments for the purchase of gas, they are payments for the failure to purchase gas).

6. In *Diamond Shamrock* the Fifth Circuit interpreted the "plain meanings of the words in the lease, and in the relevant statutes and regulations". *Id* at 1165. The unequivocal holding of the Court was that

> [i]t is obvious from a complete reading of all the relevant statutes, regulations and lease provisions, that royalties are not due on "value" or even "market value" in the abstract, but only on the value of *production saved, removed or sold* from the leased property. Likewise, the agency's regulations do not refer to "gross proceeds" in the abstract, but only to gross proceeds that accrue to the lessee from the disposition or sale of *produced substances*, that is, gas actually removed and delivered to the pipeline. Consequently, royalties are not owed

> unless and until actual production, the severance of minerals from the formation, occurs. (emphasis in original)

Id. Twice in its *Diamond Shamrock* opinion the Court makes it clear that the plain meaning of all relevant language is that royalties are due on these types of federal leases only when there has been production, meaning the severance of the minerals from the producing underground formation.

7. The unequivocal ruling of the Fifth Circuit Court of Appeals is applicable to the present undisputed fact situation. Under the ST 107 Base Contract, Enron agreed to purchase certain minimum quantities of gas from the ST 107 Lease. ST 107 Base Contract at §3.1. This minimum purchase quantity was defined in Section 1.1 of the contract as follows:

> "*Minimum Purchase Quantity*", for any month during the term of this Agreement, shall mean the minimum quantity of Gas, expressed in MMBtu per day, that Buyer is obligated to purchase and receive, or pay for if available and not taken, during such month, which quantity shall be ninety percent (90%) of the MDQ [Maximum Daily Quantity] times the number of days in such month.

Under Section 3.4 of the contract, Enron was required to make nonrecoupable payments to Century in each month in which Enron failed to purchase that minimum quantity. Under Section 11.1, Enron's monthly obligation to take minimal quantities of gas or make a nonrecoupable payment to Century for gas not taken remained in effect through March 1996. The parties subsequently extended this monthly take-or-pay obligation through October 1996.

8. Enron had identical take-or-pay obligations to Century under the West Cameron 368 Base Contract, which, as noted above, also covered Century's production from the BS 53 Lease. Under Section 3.1 of that contract, Enron was required to purchase each month certain minimum quantities of gas from the WC 368 and BS 53 Leases. Under Section 3.4 of that contract, Enron agreed to make a non-recoupable

payment to Century in each month in which Enron failed to purchase that minimal quantity. Under Section 11.1, Enron's monthly obligation to either purchase the minimum quantity of gas or make a non-recoupable payment to Century extended through September 30, 1995.

9. The $12.25 million payment that Enron made to Century was to extinguish Enron's future obligations under the ST 107 Base Contract and the WC 368 Base Contract. The calculation that Enron presented to Century when Enron offered to buy out these contracts was based on the non-recoupable payments that Enron would have made to Century during the period February 1992 through October 1996 in the event Enron did not purchase the minimum monthly quantities of gas required by those contracts. The calculation that Century presented to Enron was also based on those non-recoupable payments

10. Enron's payment to Century was not for hydrocarbons severed by production, but was to relieve Enron of its future obligations under the ST 107 Base Contract and WC 368 Base Contract to make non-recoupable payments to Century when Enron failed to purchase the minimum quantities of gas required by those contracts. The payment was the price that Century negotiated to terminate the gas purchase contracts. It was not a price paid for either present or future deliveries of severed hydrocarbons to Enron. Thus, Enron's payment is not royalty bearing under Section 8(a) of OCSLA as that section was interpreted in *Diamond Shamrock.*

11. As a further basis for this Court's ruling, the Court finds and concludes that Debtor's motion should be granted on the basis of the government's own interpretation of its "gross proceeds" rule. Rather than appeal the decision in *Diamond Shamrock,* the MMS instead formally amended the agency's "gross proceeds" regulation to conform it to the decision in the *Diamond Shamrock* case. 53 Fed Reg. 45,082 (November, 8 1988). As noted above, that decision limits "gross proceeds" to the market value of the severed

hydrocarbons at the time they are severed. Having adopted that definition, the MMS is not free in this case to expand its meaning to include payments that do not represent proceeds from severed hydrocarbons at the time those substances are severed but instead represent payments made to relieve Enron of its future obligations under natural gas purchase contracts.

12. Further reason exists to sustain the Debtor's motion based on the royalty provisions of the ST 107, WC 368, and BS 53 Leases. As noted above, those royalty provisions track the language of Section 8(a) of OCSLA. Thus, the leases limit the MMS' royalty to the value of the severed production, i.e., the produced substances, and do not permit the government to demand a royalty on non-recoupable payments made by the purchaser when the purchaser fails to purchase the required minimum quantities in accordance with its contracts. The government cannot unilaterally amend those contracts to retroactively substitute a royalty clause that is more favorable than the clause the government bargained for.

13. The Court rejects the various arguments offered by the MMS for avoiding the unambiguous holding of *Diamond Shamrock*. The MMS' argument that Enron's payment was a prepayment for gas is the exact same argument that was adopted by Judge Sear and which is discussed in *the Diamond Shamrock* case. *See* 853 F.2d at 1163. That argument, however, was rejected by the Fifth Circuit as inconsistent with Congress' intent in enacting Section 8 of OCSLA; inconsistent with the unambiguous language of the DOI's "gross proceeds" rule; and violative of the royalty provisions of the standard offshore lease form that was prepared by the government. The government's prepayment argument is rejected here for the same reasons.[1]

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[1] The government is equally incorrect in claiming that this Court should defer to the government's interpretation of the "gross proceeds" rule as set forth in *Shell Offshore Inc.*, Docket No. MMS-91-0171-OCS (September 2, 1994). There is no need or obligation to defer to an agency when a court has already issued a definitive interpretation of the statute, the implementing regulations, and the relevant contractual provisions.

14. Moreover, the Court finds that the interpretation of "gross proceeds" that is purportedly set forth in *Shell Offshore* is inconsistent with DOI's prior interpretation of that regulation based on the *Diamond Shamrock* decision. For example, in a memorandum dated November 30, 1990, the Chief of MMS' Royalty Valuation and Standard Division considered whether DOI should grant a request by Chevron, U.S.A. for a refund of the royalties that Chevron paid on certain contract payments that terminated the purchaser's future obligations under natural gas contracts involving federal oil and gas leases. That memorandum notes first that in light of the decision in *Diamond Shamrock, supra,* the MMS has adopted as its position that *"any* payment" [2] received in advance of actual production is not royalty bearing unless that production was actually severed from the lease. The memorandum then concluded:

> In keeping with this position, contract "buy-out" payments received by a producer to free a purchaser from future obligations under a sales contract are *not* associated with production removed from the lease and, therefore, will *not* be subject to royalty.[3]

NationsBank of North Carolina v. Variable Annuity Life Insurance Co., 998 F.2d 1295 (5th Cir. 1993). This is particularly true here because, as discussed above, the government did not appeal the Court's interpretation but instead amended the agency's royalty regulations to adapt that interpretation.

[2] Exhibit L to Debtor's Motion for Summary Judgment at 1 (emphasis added).

[3] Exhibit L at 1. A Field Report attached to the Chief's memorandum reached a similar conclusion:

> *Any* contract buy-out payment received by a producer to free a purchaser from future obligations under a sales contract is *not* associated with production removed from the lease and, therefore, will not be subject to royalty.

Attachment to Exhibit L at p. 5 (emphasis added).

Based on that conclusion, the royalty valuation Chief recommended that Chevron's refund request be granted. Several days later, MMS sent Chevron a letter formally approving Chevron's request for refund of the royalties the company had previously paid on contract "buy-out" revenues.[4]

15. The decision that MMS issued to Chevron was not an aberration. Both before and after it issued that decision, MMS consistently determined, directly or indirectly, that contract settlement payments of this type were not royalty bearing. *See* "Revision of Gross Proceeds Definition in Oil and Gas Valuation Regulations, Final Rule," 53 Fed. Reg. 45,082 (November 8, 1988); "Revision of Coal Product Valuation Regulations and Related Topics, Final Rule," 54 Fed. Reg. 1492, 1513 (January 13, 1989); Letter from Milton K. Dial, Chief, Royalty Valuation and Standards Division of MMS to Jerry United, ARCO Coal Co. (July 7, 1989); *Wolverine Exploration Co.*, Docket Nos. MMS-88-0052-IND and MMS-88-0096-IND (May 2, 1990); Letter from Donald T. Sant, Deputy Associate Director for Valuation and Audit of MMS to Chief, Royalty Compliance Division and Chief, RVSD (October 8, 1991).[5] Thus, at least prior to the issuance of the MMS' "Dear Payor" letter dated May 3, 1993, MMS consistently held that a contract settlement payment was *not* royalty bearing under the royalty provisions of Section 8 of the OCSLA.

16. The Court also concludes that the government's royalty claim may not lawfully be based on the May 3, 1993 "Dear Payor" letter that MMS mailed to various companies that report and pay royalties on federal oil and gas leases. [6]

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[4] Exhibit M to Debtor's Motion for Summary Judgment.

[5] Copies of these documents were attached as Exhibits O through S of Debtor's Motion for Summary Judgment. *See* also Exhibits T through W to that motion.

[6] In that letter, Mr. James W. Shaw, the Associate Director for Royalty Management, expressed his view that in some circumstances, some portion of a contract "buy-out" might be royalty bearing if the

Informal statements of agency policy never have the force and effect of law. *E.g., Mesa Operating Limited Partnership*, 125 IBLA 28 (1992), *aff'd in relevant part on reconsideration*, 128 IBLA 174 (1994). For this reason alone, the government may not properly rely on MMS' May 3, 1993 "Dear Payor" letter.

17. In the alternative, the May 3, 1993 "Dear Payor" letter exceeds the DOI's statutory, regulatory, and contractual authority under OCSLA. Under Mr. Shaw's "analysis", a "buy-out" payment to extinguish future obligations under a natural gas purchase contract can, at least in some circumstances, constitute a prepayment for gas and, as a result, become "gross proceeds accruing to the lessee for lease production" within the meaning of 30 C.F.R. § 206.152(h) (1993). As noted above, however, this argument has already been rejected by *Diamond Shamrock* and the holding of that case has been adopted by MMS.

18. Even assuming that the royalty provisions of OCSLA somehow permitted the government to claim royalties on contract payments of the type made by Enron, this Court would nonetheless be required to reject the Royalty Claim made by the government. As Debtor correctly notes, the interpretation of "gross proceeds" on which MMS relies was issued without compliance with the notice and comment requirement of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553. *See, e.g., Phillips Petroleum Co. v. Johnson*, 22 F.3d 616 (5th Cir. 1994). In that case, the Fifth Circuit recently struck down an MMS attempt to base royalty values

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"buy-out" constituted a payment for natural gas that was purchased under a follow on or a successor contract. The "Dear Payor" letter goes on to describe complicated new criteria -- nowhere found in MMS' royalty regulations -- for determining the portion of a "buy-out" payment, if any, that is royalty bearing under a successor contract, and the months during the term of the successor contract in which that portion becomes royalty bearing. A copy of that letter is attached as Exhibit N to Debtor's Motion for Summary Judgment.

for certain natural gas liquids on the values in an internal "Procedure Paper" because those values were not adopted in accordance with the rule making requirements of the APA. In short, the new royalty values informally set forth *Shell Offshore* are ineffective and unenforceable.

19. In any event, MMS' royalty claim is based on an interpretation of "gross proceeds" that is arbitrary and capricious. First, those values unfairly provide a windfall benefit to the government. As the Fifth Circuit recognized in *Diamond Shamrock*, the purpose of minimum take requirements is to apportion the risks of natural gas production and sale between the buyer and seller. 853 F.2d at 1167. Payments related to those minimum take requirements, like those required by Section 3.4 of the ST 107 and WC 368 Base Contracts, are intended to compensate the producer, not the owner of the minerals, for the risks associated with development and production:

> In fact, this is the precise reason for entering into a lease agreement. The government leases oil producing lands in order to, among other things, reap the benefits, through royalty payments, without having to shoulder the associated risks of exploration, production and development.

853 F.2d at 1167.[7] Under these circumstances, it would be completely irrational to let the government share in any revenues that the producer realized by taking those market risks while simultaneously protecting the government from any and all losses suffered by the producer from taking those same risks.

20. Permitting the government to receive royalties on contract settlement payments in the manner urged by MMS in

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[7] The government shares none of the risks or expenses of exploration, production, or development. However, the government does provide itself with a steady supply of revenue through provisions for a minimum royalty in the event there is little or no royalty bearing production. ST 107 Lease at paragraph 5; WC 368 Lease at paragraph 5; BS Lease at paragraph 5.

this case would lead to the same kinds of absurd results that troubled the Fifth Circuit in *Diamond Shamrock*. In that case, the Court found that MMS' position could, in some instance, require the lessee to make two royalty payments on one sale of gas. *Id.* at 1166. The Court also found that DOI's position could in some cases unfairly deprive producers of refunds of admitted royalty overpayments. *Id.* The Court further found that in some instances, the government's position completely distorted the concept of "fair market value" on which the government's royalty valuation rules were based. *Id.* at 1166-67.

21. The government claim in this case is based on an interpretation of "gross proceeds" that produces these same unsound and untenable results. Indeed, the government's position necessitates two royalty payments on one sale of gas in almost every case where the producer sells gas after the original contract is terminated. In that circumstance, the producer must pay one royalty based on the proceeds received for the sale of gas under the successor contract. Under the government's logic, the producer must then pay a second royalty on that same sale based on the portion of the settlement payment which MMS allocates to that sale. Thus, like the royalty values struck down in *Diamond Shamrock*, the government's claim unreasonably necessitates two royalty payments on one sale of gas.

22. In addition, MMS' position, if adopted by this Court, would unfairly deprive producers of refunds of admitted royalty overpayment and, consequently, result in undeserved royalty windfalls to the government. The government claims to have broad discretion to reallocate a settlement payment among the various issues settled (i.e., buy-down", "buy-out", pricing disputes, take-or-pay disputes, etc.) and/or among the various leases covered by the settlement.[8] By contrast, a producer has only two years in

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[8] See MMS "Dear Payor" Letter dated May 3, 1993. Moreover, there may be no time limit on such reallocations because the Fifth Circuit Court of Appeals recently held that the six year statute of limitation in 28 U.S.C.

which to seek a refund of a royalty overpayment made on a federal offshore lease. *See* 43 U.S.C. § 1339. As a result, there will be many instances in which producers will lose the right to a refund of an admitted royalty overpayment merely because of the government's lack of diligence in pursuing claims of this type.[9]

23. Finally, the government's proposed interpretation of "gross proceeds" distorts the concept of "fair market value" on which the government's royalty regulations are based. Under its position in this case, the government pretends that a payment made to terminate future obligations under an exclusive sales contract is part of the "market value" of natural gas that will be produced and sold at a later time to the same or a different purchaser. But if the purchaser does not take gas under the original exclusive contract, there is no market for that gas. With no production, there is nothing to value by market or otherwise. Claiming that any portion of the settlement payment is part of the "fair market value" of gas sold at a later time under a different contract cannot logically be supported.[10] Even if they were otherwise lawful, the governments "rules" for assessing royalties on contract "buy-outs" are arbitrary and capricious, and do not constitute a lawful basis for the royalty demand in this case.

24. The Court further concludes that, even if otherwise lawful, the government's interpretation is unlawfully retroactive under the criteria established by the *Department of Interior in Sun Exploration and Production Co.*, 112 IBLA 373 (1990). In that case, the Interior Board of Land and Appeals ("IBLA" or "Board") sharply limited the

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§ 2415 does not apply to royalty claims by MMS. *See Phillips Petroleum Co. v. Johnson*, No. 93-1377, (Slip Opinion Dated September 7, 1994).

[9] Because it gets to retain the resulting royalty windfall, the government actually has an incentive to delay challenges of this type until after the two year time limit on refunds has expired.

[10] Under the government's analysis, this sale could occur many years after the settlement payment was made and could involve a purchaser that is completely unrelated to the purchaser making the settlement payment.

circumstances in which MMS may apply a new interpretation of a regulation retroactively. Specifically, the Board rejected an MMS attempt to give retroactive effect to a new interpretation of the term "production" for purposes of applying the sliding-scale royalty provisions of a lease. As the Board stated in that case, when MMS departs from a prior administrative position and seeks to apply a new position retroactively, it is not enough for the agency to demonstrate that its new interpretation is within the meaning of the law. *Id.* at 387. Rather, the MMS has the burden of clearly setting forth and identifying its change in sufficient detail to show that the departures from the prior position was not arbitrary and capricious. *Id.* at 387-88.

25. In addition, to give its new interpretation retroactive effect, the MMS must satisfy the balancing test set out in *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 390 (D.C. Cir. 1972); *see also Runnells v. Andrus*, 484 F. Supp. 1234 (D. Utah 1980).[11]

26. In its claim, MMS has not attempted to satisfy its burden of proving that its new interpretation of "production" should be made retroactive under the criteria established by the Department of Interior itself in *Sun Exploration & Production, supra*. Nor could MMS make such a showing in view of (1) the Fifth Circuit holding in *Diamond Shamrock* concerning the royalty provisions of OCSLA; and (2) the MMS' decision to formally amend its royalty regulations in order to adopt the Court's holding in that case.

27. For the foregoing reasons, the Court concludes that the Department of Interior lacks statutory, regulatory, and

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[11] This balancing test requires the court to determine: (1) whether the case is one of first impression; (2) whether the new rule is an abrupt departure from well-established practice or merely an attempt to fill an unsettled area of law; (3) the extent to which the party against whom the new rule is applied relied on the old rule; (4) the burden which a retroactive order imposes on that party; and (5) the statutory interest in applying a new rule retroactively. *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d at 390.

contractual authority to demand a royalty on the contract settlement payment that Enron made to Century to terminate Enron's future obligations under the ST 107 Base Contract and WC 368 Base Contract. Accordingly, the Court finds that Debtor's motion for summary judgment should be sustained. This renders the government's cross-motion for summary judgment moot.

28. In light of the foregoing, there is no genuine issue as to any material fact, and Century is entitled to a judgment as a matter of law that royalties are not due on the contract settlement payment that Century received from Enron. For the same reasons, the government's cross-motion for summary judgment is denied. Judgment shall be entered accordingly.

Dated: February 13, 1995

/s/ Joe Lee
Joe Lee
United States Bankruptcy Judge

Supreme Court, U.S.
FILED
DEC 23 1997
CLERK

No. 97-706

In The

Supreme Court of the United States

October Term, 1997

CENTURY OFFSHORE MANAGEMENT CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

BRIEF OF THE JICARILLA APACHE TRIBE AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTEREST OF THE *AMICUS CURIAE*[1]

The Jicarilla Apache Tribe (the "Tribe") is an American Indian tribe recognized by the United States government and organized under Section 16 of the Indian Reorganization Act of 1934, 25 U.S.C. § 476 (1994). *See Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1982). The Jicarilla Apache Reservation (the "Reservation") is located in the northwest quadrant of the state of New Mexico, on the eastern edge of the San Juan Basin, which is the second largest natural gas field in the lower 48 states. The exterior boundaries of the Reservation have been established by a series of executive orders.[2]

The land area within the exterior boundaries of the Reservation totals approximately 980,000 acres, virtually all of which is held in trust by the United States for the Tribe. The United States holds all minerals under 900,000 acres of the Reservation in trust for the Tribe. The Tribe is the lessor and royalty owner in approximately 136 oil and

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[1] Pursuant to Rule 37.6 of the Rules of this Court, the Jicarilla Apache Tribe states that no counsel for a party authored this brief in whole or in part, and that no person or entity other than the Jicarilla Apache Tribe and its counsel made any monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.2 of the Rules of this Court, the parties have consented to the filing of this *amicus* brief. The parties' letters of consent have been filed with the Clerk.

[2] *See* Exec. Order of February 11, 1887; Exec. Order of November 11, 1907; Exec. Order of January 28, 1908; Proclamation of the Secretary of the Interior dated September 1, 1988, 53 Fed. Reg. 37355 (1988); Proclamation of the Secretary of the Interior dated September 1, 1988, 53 Fed. Reg. 37356 (1988).

gas mining leases issued under the Indian Mineral Leasing Act of 1938, 25 U.S.C. § 396a to 396g (1994), for the production of oil and gas from Reservation trust lands. The terms of those leases are prescribed by the Secretary of the Interior. *See id.* § 396b (1994); 25 C.F.R. §§ 211.1 to 211.29 (1997). Those leases cover over 300,000 acres (approximately one-third) of the Reservation. The Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. §§ 1701-1757 (1994), charges the Secretary of the Interior with the responsibility of accounting for and collecting royalties and other payments due the Tribe from oil and gas production on its Reservation. The Tribe has entered into an agreement with the Minerals Management Service ("MMS") for joint audits of oil and gas leases on the Reservation.

The Tribe has a direct and substantial interest in the proper calculation and collection of royalties under its oil and gas leases. During the period from 1990 through 1996, oil and gas production on the Reservation accounted for over 80 percent of the Tribe's governmental operating revenues. Over half of the Tribe's income from oil and gas activity consists of production royalties which are subject to MMS valuation regulations; the balance consists of tribal taxes on oil and gas activity. The Tribe relies on revenue from oil and gas production to fund the provision of essential governmental services on the Reservation, including the police department, the tribal court, emergency ambulance services, community services, alcoholic rehabilitation, day care services, elderly care, and tribal regulation of oil and gas operations.

There are approximately 100 lessees and operators on the Reservation operating under the oil and gas leases

subject to MMS supervision. Three major gas pipeline companies provide gathering and transportation services to these lessees and operators. Many of the lessees and operators on the Reservation have entered into settlements with those pipeline companies concerning termination of long-term gas-purchase contracts, many of which contracts imposed take-or-pay liability on the pipeline companies. The Tribe has a direct economic interest in the extent to which those settlement payments give rise to royalty obligations.

ARGUMENT

I. THE INTERPRETATION OF FEDERAL MINING LEASES WILL AFFECT MINING LEASES OF INDIAN LANDS, WHICH CONTAIN ROYALTY CLAUSES SIMILAR TO THOSE CONTAINED IN THE FEDERAL LEASES

The royalty clause in the federal lease interpreted by the Sixth Circuit in this case is substantially similar to the royalty clause in the leases drafted by the Department of the Interior for oil and gas production on the Jicarilla Apache Reservation. The federal leases authorize the Department of the Interior (the "Department") to collect royalties on the "amount or value of production saved, removed or sold" from the leased premises. *See In re Century Offshore Management Corp.*, 111 F.3d 443, 445 (6th Cir. 1997) (citing Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331-56 (1996)). Similarly, the Indian leases authorize the Department to collect royalties on "the

value or amount of all oil, gas, and/or all other hydrocarbon substances produced and saved from" the leased land. *See Independent Petroleum Assoc. of America v. Babbitt*, 92 F.3d 1248, 1252 (D.C. Cir. 1996) (citing 43 U.S.C. § 1337(a)(1)(A); 30 U.S.C. § 226(b); 25 C.F.R. § 211.13 (1995); 25 C.F.R § 212.16 (1995)); *id.* at 1262 n.8 (Rogers, J., dissenting). Resolution of the question whether lump sum payments made to settle take-or-pay contracts are royalty bearing under the royalty clause of the federal-land leases will affect the Department of the Interior's assessment of royalties on such payments associated with leases of the Tribe's lands.

II. THE UNITED STATES HAS TRUST OBLIGATIONS TO INDIAN TRIBES; THESE TRUST OBLIGATIONS REQUIRE THE DEPARTMENT TO MAXIMIZE ROYALTIES ASSESSED ON INDIAN LANDS

The United States acts as a trustee to dependent Indian tribes. *See generally Seminole Nation v. United States*, 316 U.S. 286 (1942). When assessing royalties on oil and gas production from Indian lands, the Secretary of the Interior's actions are evaluated under a stringent, lessor-oriented standard that requires the Secretary to act according to his fiduciary obligations to the Indian lessor. *Jicarilla Apache Tribe v. Supron Energy Corp.*, 728 F.2d 1555, 1563 (10th Cir. 1984), *dissenting opinion of J. Seymour adopted as majority en banc opinion*, 782 F.2d 855 (10th Cir. 1986) (Because the Secretary of Interior is obligated to act as a fiduciary to the Indian lessor in administration of the Indian lessor's oil and gas reserves, "his actions must not merely meet the minimal requirements of administrative

law, but must also pass scrutiny under the more stringent standards demanded of a fiduciary."); *see also, e.g., Cheyenne-Arapaho Tribes of Oklahoma v. United States*, 966 F.2d 583, 589 (10th Cir. 1992); *Assiniboine and Sioux Tribes v. Board of Oil and Gas Conservation*, 792 F.2d 782, 794 & 794 n.15 (9th Cir. 1986). The Secretary's trust obligations to Indian royalty owners must be considered in evaluating the question whether take-or-pay settlement payments are royalty-bearing.

III. THE FIFTH, SIXTH, EIGHTH, AND DISTRICT OF COLUMBIA CIRCUITS HAVE REACHED INCONSISTENT RESULTS AND HAVE ADOPTED INCONSISTENT ANALYSES TO DECIDE WHETHER A SETTLEMENT PAYMENT MADE TO EXTINGUISH TAKE-OR-PAY LIABILITY IS ROYALTY BEARING

A. Explanation of Take-or-Pay Settlement Payments

The cases discussed below involve disputes over whether lump-sum payments made by gas pipeline companies to gas producers to settle large take-or-pay liabilities accrued under long-term gas-purchase contracts are properly subject to royalty. This issue arises from a fundamental change in the natural gas industry over the past decade. Many pipeline companies entered into long-term gas-purchase contracts with gas producers who were lessees of federal, Indian, state and private lands. Many of these contracts contained "take-or-pay" provisions, which required the pipeline company to pay for much of the contracted-for gas even if it did not take the gas. Often, the take-or-pay payments were "recoupable," meaning that the pipeline company could credit these payments toward "make-up gas" taken at a later date.

In the 1980's the Federal Regulatory Energy Commission began a major deregulation of wellhead prices of natural gas. After deregulation, the market price for gas dropped well below the long-term contract prices the pipeline companies were committed to pay. As a result, these long-term gas-purchase contracts, in particular the take-or-pay provisions, became extremely burdensome for the pipeline companies. Many of them settled the long-term gas-purchase contracts with the producers by making a lump-sum settlement payment to extinguish the pipeline company's obligations under these contracts, including the pipeline company's take-or-pay obligations.

The cardinal issue in the cases discussed below is whether those take-or-pay settlement payments are properly royalty bearing. As will become evident from the following discussion, the respective Circuit Courts of Appeals have diverged widely on this question, both in terms of the results reached and the analysis applied.

B. Survey of the Approaches Taken by the United States Courts of Appeals on the Question Whether Lump-Sum Payments Made to Extinguish Take-or-Pay Liability are Royalty Bearing

The first United States Court of Appeals case to address the issue of whether take-or-pay payments are royalty bearing was the Fifth Circuit in *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988). *Diamond Shamrock* did not involve a settlement payment, but rather addressed the issue of whether take-or-pay payments during the life of a gas-purchase contract are royalty bearing. The royalty provision in the lease at

issue in *Diamond Shamrock* required the lessee-producer on federal lands to pay the federal government as lessor a royalty of "16$^{2}/_{3}$ percent in amount or value of production saved, removed or sold from the leased area." *Id.* at 1163 (footnote omitted). The Fifth Circuit held that royalties are due on take-or-pay payments only when those payments are recoupable and make-up gas is taken. *Id.* at 1168. The holding in *Diamond Shamrock* was based on the Court's conclusion that the royalty clause and the applicable federal regulations required a direct link between royalties and the production of gas (i.e. physical severance of the gas from the ground). The Court reasoned that, if a take-or-pay payment is nonrecoupable or if make-up gas to which the payment is credited is not taken, the requisite link between the take-or-pay payment and production of gas is not present, and no royalty may be assessed on the take-or-pay payment. *Id.* at 1168. This is because "[f]ar from being payments for the purchase of gas, take-or-pay payments are payment for the pipeline-purchaser's failure to purchase (take) gas," which failure is not directly associated with production *Id.* at 1167 (footnote omitted). The Court also based its holding on the observation that "[t]ake-or-pay payments are intended to compensate primarily the producer, not the owner of the minerals, for the risks associated with development production." *Id.* In addition, the Court noted that assessing royalties on take-or-pay payments would present formidable accounting problems that should be avoided. *Id.* at 1166.

In *Frey v. Amoco Production Co.*, 943 F.2d 578 (5th Cir. 1991), *withdrawn in part*, 951 F.2d 67 (5th Cir.), *original opinion reinstated in part*, 976 F.2d 242 (5th Cir. 1992), the

Fifth Circuit revisited the take-or-pay issue and held that a private (i.e., non-federal, non-Indian) lessor was entitled to royalties on a settlement payment relieving take-or-pay liability under a long-term gas-purchase contract. The Fifth Circuit panel in *Frey* distinguished *Diamond Shamrock* on the ground that the royalty clause in the lease construed in *Diamond Shamrock* was different from the royalty clause in the lease at issue in *Frey*. In *Frey*, the royalty on gas sold by the lessee was set at "one-fifth (1/5) of the amount realized at the well from. . . sales" of gas. *Id.* at 582 n.2. In addition, the panel in *Frey* was applying the state law of Louisiana, not federal law, to the interpretation of the lease. *Id.* at 581. Nonetheless, the panel in *Frey* distanced itself from certain central tenets of the *Diamond Shamrock* analysis, and applied an analysis and reached a result vastly different from those in *Diamond Shamrock*. The *Frey* panel rejected the argument that accounting difficulties that may arise from assessing royalties on take-or-pay payments can constitute a reason for holding that take-or-pay payments are not royalty bearing. The *Frey* panel stated: "we know of no authority for the proposition that accounting complications should abrogate legal rights." *Id.* at 583 n.4. The panel in *Frey* adopted an economic analysis of the take-or-pay payments that differs dramatically from the *Diamond Shamrock* analysis. The *Frey* panel's economic analysis is excerpted as follows:

> The [take-or-pay] payments, like the market price paid for gas taken, constitute economic benefits that [the lessor] received from granting [the lessee] the right to take gas from the leased premises, a right that [lessee] got through the Lease. It would be contrary to the nature of the

> lease as a cooperative venture to allow a benefit by any name that is attributable to the gas under the leased premises to inure exclusively to the lessee.
>
> . . . .
>
> If lessors did not share in take-or-pay payments, lessees would have an incentive to compromise volume gas prices under their contracts or settlements with pipelines in exchange for favorable take-or-pay terms.

Id. at 584-85 (footnotes omitted). This analysis recognizes that take-or-pay payments are consideration the lessee enjoys that is derived from the right the lessor has granted to the lessee to extract gas from the lessor's land. The take-or-pay payment is an economic benefit directly derived from this grant of rights from the lessor to the lessee, and "[i]t would be contrary to the nature of the lease" to allow this benefit to inure solely to the lessee. This analysis contradicts the *Diamond Shamrock* analysis that take-or-pay payments, as "payment for the pipeline-purchaser's failure to purchase gas," are not linked closely enough with production to be royalty bearing unless associated with gas actually produced. *Diamond Shamrock*, 853 F.2d at 1167. The *Frey* panel explicitly acknowledged that its characterization of the nature of take-or-pay payments might "contradict *Diamond Shamrock's* assertion that 'take-or-pay payments are payment for the pipeline-purchaser's failure to purchase . . . gas.' " *Frey*, 943 F.2d at 584 n.5 (quoting *Diamond Shamrock*, 853 F.2d at 1167).

The Eighth Circuit in *Klein v. Jones*, 980 F.2d 521 (8th Cir. 1992), held that a class of approximately 3000 non-

federal, non-Indian lessors, who brought an action against the lessee/producer seeking a portion of moneys paid by a pipeline company in a settlement relieving take-or-pay liabilities and effectuating a contract buydown, were entitled to relief both on a theory of unjust enrichment and on breach of an implied covenant to market gas. *Id.* at 533. The royalty clause in the lease at issue in *Klein* included "amount realized from [the sale of gas]" language similar to that in the lease before the court in *Frey*. The Eighth Circuit employed an economic analysis similar to that employed by the Fifth Circuit panel in *Frey*, and held that the settlement was royalty bearing. Aware that the settlement payment constituted an economic benefit to the lessee that directly originated in the lease arrangement between the lessee and the lessor, the Court stated that " 'it would be contrary to the nature of the lease as a cooperative venture to allow a benefit, *by any name*, that is attributable to the gas under the leased premises to inure exclusively to the lessee.' " *Klein*, at 530 (quoting *Frey*, 943 F.2d at 584; emphasis added). The Court also added that to permit " 'either the lessor or the lessee to receive a part of the gross revenues from the property greater than the fractional division contemplated by the lease, should be considered inherently contrary to the basic nature of the lease. . . . ' " *Id.* at 531 (quoting *Henry v. Ballard & Cordell Corp.*, 418 So.2d 1334, 1338 n.10 (La. 1982)); *see also id.* at 533 (Bright, J., concurring) ("[The lessees] may have reaped a substantial benefit from the lease that purported to be unrelated to the production of gas. This result would conflict with the underlying purpose of the lease, which is for the lessor to receive a share of all proceeds generated by the land, and

may have resulted in [the lessees] receiving a potentially unjust enrichment.").[3]

Independent Petroleum Association of America v. Babbitt, 92 F.3d 1248 (D.C. Cir. 1996) (*"IPAA"*), involved the situation where (a) a pipeline company paid Samedan Oil Corporation (a producer/lessee on Indian lands) a lump sum nonrecoupable settlement payment to extinguish its liabilities under a take-or-pay contract and (b) Samedan simultaneously entered into a substitute contract with a new purchaser for the gas that was freed up by the settlement. *Id.* at 1254. The royalty clause in *IPAA* was similar to the royalty clause in *Diamond Shamrock*. Relying on *Diamond Shamrock*, the District of Columbia Circuit held that nonrecoupable settlement payments were not royalty bearing, because in the absence of recoupment (i.e. the taking of make-up gas), there was not a sufficient nexus between the settlement payment and actual production of gas. *Id.* at 1259-60. The dominant consideration in *IPAA* was whether the settlement payment was recoupable. *Id.* at 1259 ("a nonrecoupable settlement payment is *never* credited as payment for any gas actually severed from the ground.") (emphasis added).

Finally, in the case at bar, the Sixth Circuit upheld MMS's royalty assessment on a nonrecoupable settlement

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[3] The Eighth Circuit subsequently reaffirmed the position it had taken in the original *Klein* decision. *See Klein v. Arkoma Prod. Co.*, 73 F.3d 779, 786 (8th Cir.) (holding lessee violated implied covenant to market when it did not pay royalty owners a proportionate share of settlement payment relieving take-or-pay liability; also holding for lessor on unjust enrichment grounds), *cert. denied*, 117 S. Ct. 65 (1996).

payment made to extinguish a contract imposing take-or-pay liability. *In re Century Offshore Management Corp.*, 111 F.3d 443 (6th Cir. 1997), Century Offshore Management Corporation ("Century") was the lessee of federally-owned submerged lands in the Gulf of Mexico. *Id.* at 445. Century sold gas to Enron Gas and Marketing, Inc. ("Enron") under a take-or-pay contract. *Id.* Enron paid Century a $12,250,000 lump-sum payment to terminate that contract and replace it with a new contract – between the same two parties – based on the current, floating market price for gas. *Id.* The lease in *Century* included a royalty clause turning on "amount or value of the production saved, removed, or sold by the lessee," which is similar to the royalty clauses in the leases at issue in *Diamond Shamrock* and *IPAA*, and which did not expressly refer to the "amount realized from the sale of gas" as did the royalty clauses in *Frey* and *Klein*. The Sixth Circuit upheld MMS's assessment of royalty on the take-or-pay settlement payment when gas was actually produced under the substitute contract, because it viewed the settlement of the take-or-pay contract and the substitute contract to be interrelated transactions, and viewed the initial settlement as an advance payment for the gas eventually produced under the substitute contract. *Century*, 111 F.3d at 448-49. The Court cited to the definition of "gross proceeds" in the regulations pertaining to federal leases, which are defined as " 'the total monies and other consideration accruing to an oil and gas lessee for the disposition of oil or gas produced.' " *Id.* at 446 (quoting 30 C.F.R. § 206.151 (1996)).

The Sixth Circuit focussed on the fact that the parties to the settled contract and the parties to the substitute

contract were the same, and thus viewed the settlement payment as a prepayment for gas produced in the future. By contrast, in *IPAA* the District of Columbia Circuit's application of the *Diamond Shamrock* analysis to the settlement payment context centered on whether the settlement payment was recoupable. *See IPAA*, 92 F.3d at 1259. The *Century* and *IPAA* cases involved leases with virtually identical royalty provisions, and thus cannot be distinguished on that basis.

C. Analysis of the Divergence Among the Circuits on this Issue

There is a broad divergence among the Circuits over whether royalties may be assessed on take-or-pay payments and settlement payments intended to relieve take-or-pay liability. To a substantial degree, this divergence results from different understandings of the economic functions of the take-or-pay obligations. The Fifth Circuit in *Frey* and the Eighth Circuit in *Klein* looked at the relationship among the lessor, lessee and pipeline company and concluded that the lessee's right to enjoy take-or-pay payments is derived from the rights the lessor granted to the lessee, and that the nature of the lease relationship required the lessee to share those payments with the lessor through the royalty clause. By contrast, the Fifth Circuit panel in *Diamond Shamrock* viewed take-or-pay payments merely as payments intended to compensate the lessee/producer for the purchaser's failure to take gas and for the risks associated with production that the lessee, not the lessor, bears. The Fifth Circuit in *Diamond Shamrock* therefore concluded that those payments

are not royalty bearing unless and until make-up gas is taken. *IPAA* followed the *Diamond Shamrock* analysis and directed its attention to whether the settlement payment was recoupable. The Sixth Circuit in *Century* diverged from *IPAA*, focused on the fact that the parties to the settled and substitute contract were the same, and viewed the settlement payment as a *de facto* prepayment for gas produced under the substitute contract. These divergent approaches to the same issue have generated inconsistent results and substantial uncertainty as to whether a specific take-or-pay settlement payment will be royalty bearing under a specific royalty clause.

The differences in the language of the respective royalty clauses cannot explain the fundamentally different approaches to this issue adopted by the various Circuits. It is true that royalty clauses in *Klein* and *Frey* based royalty on the "amount realized from [the sale of gas]," while the royalty clause in *Diamond Shamrock* based royalty on the "amount or value of production saved, removed or sold from the leased area." However, *IPAA* and *Century* both involved royalty clauses of the *Diamond Shamrock* variety, yet reached different results from one another. Moreover, the federal regulations governing federal and Indian leases eliminate any purported distinction between a "value of production" royalty and an "amount realized" royalty in this context. The regulations governing royalty in Indian leases base royalty on the value of minerals produced, but also use the amount realized from the sale of the minerals in determining that value. *See* 25 C.F.R. § 211.13(a) (1996) ("The lessee shall pay . . . a royalty of 12½ percent of the value or amount of all oil, gas and/or natural gasoline, and/or other

hydrocarbon substances produced and saved from the land leased. . . . The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary of the Interior, be deemed mere evidence of or conclusive evidence of such value.").[4]

Likewise the applicable federal valuation regulations unambiguously set forth that the value of gas includes "the total consideration actually transferred either directly or indirectly from the buyer to the seller for the gas." 30 C.F.R. § 206.152(b)(1)(ii) (1996):

> In conducting reviews and audits, MMS will examine whether the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the gas. If the contract does not reflect the total consideration, then the MMS may require that the gas sold pursuant to that contract be valued [under a constructive arms-length contract]. Value may not be less than the gross proceeds accruing to the lessee, including the additional consideration.

See also id. § 206.152(b)(3) ("MMS may require a lessee to certify that its arm's-length contract provisions include all of the consideration to be paid by the buyer, either directly or indirectly, for the gas."). These regulations are intended in part to prevent self-serving contracts between

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[4] This language has been incorporated directly into leases issued by the Secretary of the Interior on Indian lands. *See* Bureau of Indian Affairs Lease Form 5-137, § 3(c) ("The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary, be deemed mere evidence of or conclusive evidence of such value.").

lessees and purchasers of production that deprive the lessor of a royalty on a benefit the lessee has derived from the lessor's land. These federal regulations demonstrate the futility of trying to reconcile the decisions of the Circuit Courts by reference to the different royalty clauses. Under those regulations the "amount realized" by the producer is simply one way of determining the "value of production" for purposes of royalty. Accordingly, the Tribe submits that the real issue underlying the varied outcomes of these cases is whether the economic analysis employed by *Klein* and *Frey*, or the economic analysis employed by *Diamond Shamrock*, to evaluate take-or-pay settlement payments is correct. The Tribe further submits that the *Klein/Frey* analysis comports with the Secretary of the Interior's trust obligations to maximize royalties on Indian lands, while the *Diamond Shamrock* analysis does not.

As discussed above in Section I, the language setting forth the basis on which royalties are assessed on federal leases is similar to the language defining the royalties on Indian leases. The Tribe respectfully suggests that this Court grant the petition for a writ of certiorari in order to set forth which of the conflicting analyses among the circuits discussed above is correct. Such clarification would provide guidance to the Secretary in assessing royalties on lump-sum settlement payments between producers and pipeline companies extinguishing take-or-pay liability on the Jicarilla Apache Reservation.

CONCLUSION

For the foregoing reasons, the Jicarilla Apache Tribe respectfully suggests that this Court grant Century Offshore Management Corporations's petition for a writ of certiorari.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1997

CENTURY OFFSHORE MANAGEMENT CORPORATION,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTIONS PRESENTED

Lessees producing natural gas under federal (and Indian) leases administered by the Secretary of the Interior have received substantial lump-sum payments from gas purchasers in settlement of previous contractual obligations to purchase gas. The questions presented are:

1. Whether the Secretary may require the payment of royalties on the portion of those settlement payments that is allocable to gas (i) originally covered by the settled contract and (ii) later actually produced and sold by the lessee.

2. Whether the court of appeals applied an inappropriate standard of review to the bankruptcy court's construction of two related contracts.

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In the Supreme Court of the United States

OCTOBER TERM, 1997

No. 97-706

CENTURY OFFSHORE MANAGEMENT CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-19a) is reported at 111 F.3d 443. The opinion of the district court (Pet. App. 21a-36a) is unreported. The opinion of the bankruptcy court (Pet. App. 37a-52a) is reported at 185 B.R. 734.

JURISDICTION

The judgment of the court of appeals was entered on April 14, 1997. A petition for rehearing was denied on July 23, 1997. Pet. App. 20a. The petition for a writ of certiorari was filed on October 21, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Under the Outer Continental Shelf Lands Act (OCSLA or the Act), 43 U.S.C. 1331 *et seq.*, and similar federal statutes, leases for the development of federal oil and gas resources generally call for the payment of a royalty equal to a specified percentage of the "value of the production saved, removed, or sold" by the lessee during the term of the lease. 43 U.S.C. 1337(a)(1) (offshore leases).[1] The OCSLA further directs the Secretary of the Interior to "administer the [Act's] provisions * * * relating to the leasing of the outer Continental Shelf" and to "prescribe such rules and regulations as may be necessary to carry out such provisions." 43 U.S.C. 1334(a); see also 30 U.S.C. 189; 25 U.S.C. 396, 396d. Under the Secretary's regulations, the "value of production" for royalty purposes is "under no circumstances" to be less than the "gross proceeds accruing to the lessee for lease production." 30 C.F.R. 206.152(h); see also 30 C.F.R. 206.153(h).[2] "Gross proceeds" is defined to mean "the total monies and other consideration accruing to [a] * * * gas lessee for the disposition of" gas, 30 C.F.R. 206.151, without regard to any

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[1] See also 30 U.S.C. 181, 226 (1994 & Supp. I 1995) (onshore leases under the Mineral Lands Leasing Act of 1920); 25 U.S.C. 396, 396a-396g (federally administered leases on Indian tribal and allotted lands); 25 C.F.R. 211.13 (tribal leases), 212.16 (allotted leases) (1996); 25 C.F.R. 211.41(b), 212.41(b) (1997) (amended regulations now applicable to Indian leases).

[2] The Secretary first promulgated a similar "gross proceeds" rule for onshore leases in 1936. 1 Fed. Reg. 2000 (§ 3(e)). The rule was first applied to offshore leases under the OCSLA in 1954. 19 Fed. Reg. 2659 (1954); 30 C.F.R. 250.64 (1955). The present rule applies to all federal and Indian leases.

particular characterization or "bookkeeping device" adopted by a lessee. *Kerr-McGee Oil Indus., Inc.*, 70 Interior Dec. 464, 469-470 (1963); see *Wheless Drilling Co.*, 80 Interior Dec. 599 (1973); *Hoover & Bracken Energies, Inc.* v. *United States Dep't of Interior*, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

It was at one time typical for companies producing natural gas under federal leases to enter into long-term contracts with pipeline operators, under which the producer agreed to dedicate certain gas reserves to a particular pipeline customer, in return for the pipeline's agreement to purchase no less than specified quantities of gas at specified prices. See generally, *e.g.*, *Independent Petroleum Ass'n of America* v. *Babbitt*, 92 F.3d 1248, 1251 (D.C. Cir. 1996) (*IPAA*). Many contracts also contained "take-or-pay" clauses, under which the purchaser agreed to pay for a minimum volume of gas during a specified period, even if it did not accept delivery of the full amount for which it paid. See *Mobil Oil Exploration & Producing Southeast, Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 220-221 & n.3, 229 (1991). Most such provisions allowed the purchaser considerable time in which it could recoup, or "make up," a take-or-pay payment by applying the amount of the payment as a credit against the purchase price of gas taken in a later period in excess of the minimum required for that period under the contract ("make-up" gas). See *IPAA*, 92 F.3d at 1251; Pet. App. 4a & n.1; *Diamond Shamrock Exploration Co.* v. *Hodel*, 853 F.2d 1159, 1164 (5th Cir. 1988).

In the 1980s, market changes and a restructuring of the natural gas industry contributed to a significant drop in the price of gas. See *IPAA*, 92 F.3d at 1251.

Those changes caused pipeline companies to seek relief from the long-term, high-priced purchase commitments previously typical in the industry. Negotiations between purchasers and producers typically led to settlements under which the purchaser paid a lump sum to the producer, in return for which the producer agreed either to sell gas to the same purchaser at a lower price (a buydown), or simply to release the purchaser from any obligation to buy gas under the previous contract (a buyout). See *id.* at 1251-1252; compare Pet. App. 5a. Many settlements also included lump-sum compromises of accrued but unpaid take-or-pay liabilities. See *IPAA*, 92 F.3d at 1252.

2. Petitioner produced natural gas under federal offshore leases that it acquired between 1987 and 1990. Pet. App. 3a-4a. In 1989 and 1990, petitioner entered into a number of contracts with Enron Gas Marketing, Inc. (Enron), for the sale of gas from those leases. The contracts included both "base" contracts, which required Enron to buy minimum quantities of gas at fixed prices, and "excess" contracts, which permitted Enron to purchase additional quantities at floating prices tied to the spot market. *Id.* at 4a-5a.

By late 1991, the spot-market price for gas had declined below the price fixed in the base contracts. See Pet. App. 23a. On February 14, 1992, Enron and petitioner entered into an agreement under which Enron agreed to pay petitioner $12.25 million, subject to the "simultaneous" execution of additional agreements that (i) terminated the original base and excess contracts and (ii) substituted new purchase contracts designed to "supersede and replace" the previous contracts "in their entirety." C.A. App. 347 (letter agreement); see also Pet. App. 5a; Pet. Supp. C.A. Br. Exh. B-D (new contracts). The agreement also pro-

vided that Enron would loan petitioner up to $1.5 million to pay any royalties that the Secretary might determine to be payable, under certain leases, in respect of the $12.25 million payment. C.A. App. 348; see Pet. App. 5a.

3. Petitioner later filed a voluntary petition for bankruptcy. The United States filed a proof of claim for $1,855,004, representing petitioner's total potential liability for royalties on the $12.25 million contract settlement payment it received from Enron. Pet. App. 5a-6a, 37a-38a.[3] Petitioner objected to the government's proof of claim. *Id.* at 38a.

a. The bankruptcy court granted summary judgment for petitioner, on the ground that the Enron settlement payment was not part of petitioner's "gross proceeds" under its federal leases, and therefore gave rise to no royalty liability. Pet. App. 37a-52a. In its findings of fact, the court recited that Enron had paid petitioner $12.25 million in a "Termination of Gas Purchase Agreements." *Id.* at 40a (¶ 10). In its conclusions of law, the court characterized that payment as one "to relieve Enron of its future obligations under the" base contracts, and "not a price paid for either present or future deliveries of severed hydrocarbons to Enron." *Id.* at 43a (¶ 10). Neither the court's findings nor its conclusions mentioned the existence, or addressed the significance, of petitioner's simultaneous agreement with Enron for the continued sale of gas at new prices.

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[3] Because the Secretary's royalty claim was first made in petitioner's bankruptcy proceeding, there was no administrative proceeding concerning royalties on the settlement proceeds, and the Secretary has never issued a formal administrative determination or order with respect to this case.

On the basis of its findings and conclusions concerning petitioner's contractual arrangement with Enron, the court held that the Fifth Circuit's decision in *Diamond Shamrock Exploration Co.* v. *Hodel*, which held that the Secretary could not demand a royalty on a take-or-pay payment unless and until make-up gas was actually produced and sold, compelled the conclusion that Enron's payment was not part of the "value of production" subject to royalty under petitioner's federal leases. Pet. App. 40a-43a. The court rejected the government's argument that the payment was, in effect, a partial prepayment for the later sale of gas under the superseding purchase contracts. *Id.* at 44a. It believed, furthermore, that the Secretary had previously acquiesced in the construction of *Diamond Shamrock* adopted by the court; and that, having done so, he was not free to assess royalties on the payment at issue in this case. *Id.* at 43a-44a. The court expressly refused to defer to the Secretary's contrary position, on the grounds that that position was arbitrary and capricious, had been adopted without compliance with the notice-and-comment provisions of the Administrative Procedure Act (APA), 5 U.S.C. 553, and was impermissibly retroactive. *Id.* at 45a-52a.

b. The district court affirmed. Pet. App. 21a-36a. That court, too, refused to defer to the Secretary's construction of the applicable statute and regulations. *Id.* at 27a-33a. It held that the decision in *Diamond Shamrock* represented "a definitive interpretation of the statute, the implementing regulations, and the relevant contract provisions," and that there was therefore "no need or obligation for [the] Court to defer" to the Secretary's position. *Id.* at 30a. The

court also rejected the Secretary's position as "impermissible" on the ground that "interpreting 'gross proceeds' to include payments made not for natural gas but rather to terminate a contractual obligation * * * exceeded [the Secretary's] statutory, regulatory, and contractual authority." *Id.* at 30a-31a. Alternatively, the court concluded that the Secretary's interpretation of the "gross proceeds" regulation was "arbitrary and capricious" (*id.* at 31a-33a) and "unlawfully retroactive" (*id.* at 33a-34a). The court reversed, however, the bankruptcy court's holding that the Secretary's interpretation had not been properly adopted under the APA. *Id.* at 34a-35a.

c. The court of appeals reversed. Pet. App. 1a-19a. Observing first that interpretation of the contractual relationship between petitioner and Enron was "a matter of law subject to *de novo* review" (*id.* at 8a n.3), the court held that the termination of the 1989 and 1990 purchase contracts and their simultaneous replacement by the 1992 purchase contracts constituted "one transaction for the purposes of the instant dispute" (*id.* at 8a). It then concluded that the lump-sum payment made by Enron as part of that transaction "contemplated and was the cause of new gas sales to be delivered in the future" as part of the "continuing relationship" intended by the parties, and therefore "behaved as an advance payment under a substituted requirements contract." *Id.* at 9a. Thus, although, as with any advance-payment contract, "the government would not be entitled to its royalties until production" of the purchased gas, the lump-sum payment "was for 'production sold' under the statute, and the royalty was payable when the gas was produced." *Ibid.*

The court rejected petitioner's argument that the decision in *Diamond Shamrock* required a contrary result. Pet. App. 9a-11a. The court noted that *Diamond Shamrock* addressed only "the royalty consequences of take-or-pay payments" when they were first made. *Id.* at 9a. Thus, the court below explained, as a practical matter *Diamond Shamrock* affected primarily the timing of royalties on such payments, permitting the government to collect them only "if and when make-up gas is actually produced." *Id.* at 10a. Reading *Diamond Shamrock* to require only "some nexus with production" before a payment could become subject to royalties (*ibid.*), the court held (*id.* at 11a) that the necessary nexus "exist[ed] under the facts of th[is] case" because "virtually all" the gas originally covered by the 1989 and 1990 contracts was ultimately purchased by Enron under the "simultaneous replacement contracts" signed by the parties in 1992. Once that gas was produced and sold to Enron under the replacement contracts, "royalty payments [became] due, not merely on the price Enron ultimately paid, but on that price plus the amount of the lump sum payment allocable to the gas ultimately taken." *Ibid.*

The court similarly rejected petitioner's contention that the Secretary's response to *Diamond Shamrock* foreclosed his position in this case. Pet. App. 11a-12a. The court noted that, rather than further contesting the holding in *Diamond Shamrock*, the Secretary had amended his royalty regulations to accept and adopt a "very narrow interpretation" of that decision. *Id.* at 11a. The court explained, however, that, although the regulatory amendments retreated from the position that royalties on take-or-pay payments were due as soon as the payments were

made, "[t]he government never conceded * * * that it would not seek royalties once a sufficient link to production [was] established." *Id.* at 11a-12a. Again construing petitioner's simultaneous agreements with Enron as "one transaction," the court held that they provided just such a "link" between Enron's lump-sum payment and petitioner's later production under the superseding purchase contracts. *Id.* at 12a.

The court sought to distinguish the D.C. Circuit's decision in *Independent Petroleum Association of America* v. *Babbitt*, which had held that the Secretary was not entitled to any royalty on a lump-sum settlement payment made by a gas purchaser to terminate its obligations under a contract with a federal lessee (and to compromise take-or-pay liabilities previously accrued under that contract). Pet. App. 14a-15a. Noting that the gas covered by the contract settled in *IPAA* was subsequently sold, not to the settling purchaser itself, but to a third-party, the court characterized that case as involving "a situation in which a nexus with production did not exist." *Id.* at 15a. In the court's view, it was "not at all clear how the [*IPAA*] court would have dealt with the instant case." *Ibid.*; see also *id.* at 6a n.2.

Finally, the court of appeals "d[id] not find compelling" the arguments advanced by petitioner and the lower courts that acceptance of the Secretary's position would lead to arbitrary or "absurd" results (Pet. App. 13a-14a), and it rejected (*id.* at 16a-19a) petitioner's arguments based on the asserted "retroactivity" of the Secretary's construction and on the notice-and-comment requirements of the APA. The court therefore reversed the district court's decision on the royalty question, and remanded the matter for

a determination of the amount of the royalty due. *Id.* at 19a.

DISCUSSION

The court of appeals in this case correctly held that a federal lessee owes royalties on a lump-sum payment made by a gas purchaser to settle or terminate its contractual purchase obligations, if and to the extent the lessee later produces and sells gas previously covered by the settled contract. That decision conflicts, however, with the decision of another court of appeals, and we are informed that the federal royalties at stake in connection with such transactions amount to several hundred million dollars. We therefore agree with petitioner that the first question presented by the petition merits this Court's review.[4]

1. As we have explained (see pages 2-3, *supra*), federal leasing statutes, including the Outer Continental Shelf Lands Act (OCSLA or the Act), generally require the payment of royalties calculated as a

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[4] Petitioner also seeks review of whether the court of appeals improperly disturbed the bankruptcy court's "findings of fact." Pet. i, 15-17. That argument apparently relates to the court's conclusion (Pet. App. 8a-9a & n.3) that petitioner's 1992 agreements with Enron should be treated as "one transaction" for purposes of this case. That conclusion was based on the court's evaluation and construction of the parties' overall contractual relationship—a legal issue properly subject to de novo review. *Id.* at 8a n.3; see also *Klein* v. *Arkoma Prod. Co.*, 73 F.3d 779, 785 (8th Cir.), cert. denied, 117 S. Ct. 65 (1996). Indeed, the bankruptcy court, on whose "findings" petitioner seeks to rely, took the same view: The only "factual findings" to which petitioner alludes (Pet. 16) are set out in that court's opinion as "conclusions of law" (Pet. App. 40a, 43a). This case thus presents no standard-of-review question that might warrant review by this Court.

percentage of the "value of the production saved, removed, or sold" by a federal lessee during the term of a lease. 43 U.S.C. 1337(a)(1). Exercising his statutory authority to administer the OCSLA and to "prescribe such rules and regulations as may be necessary to carry out [its] provisions," 43 U.S.C. 1334(a), the Secretary of the Interior has specified that the "value of production" for royalty purposes is "under no circumstances" to be less than the "gross proceeds accruing to the lessee for lease production." 30 C.F.R. 206.152(h); see also 30 C.F.R. 206.153(h).

The Secretary further defines "gross proceeds" to mean "the total monies and other consideration accruing to [a] * * * gas lessee for the disposition of" gas. 30 C.F.R. 206.151. In this and other cases, the Secretary has consistently interpreted that definition of "gross proceeds" to include lump-sum payments made to a lessee in settlement of contractual commitments to purchase gas, if and when the lessee thereafter produces and sells the gas that would otherwise have been subject to the settled obligation. See *Shell Offshore, Inc.*, MMS-91-0087-OCS (Sept. 2, 1994); *Samedan Oil Corp.*, MMS-94-0003-IND (Sept. 16, 1994). Finally, the Secretary has long insisted that all royalty valuation questions, including the amount of a lessee's gross proceeds, be resolved on the basis of economic substance, rather than as a matter of mere transactional form.[5]

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[5] See, *e.g.*, note 6, *infra*; *Enron Oil & Gas Co.* v. *Lujan*, 978 F.2d 212, 215-216 (5th Cir. 1992) (reimbursement for severance taxes included in "gross proceeds"), cert. denied, 510 U.S. 813 (1993); *Mesa Operating Ltd. Partnership* v. *United States Dep't of Interior*, 931 F.2d 318, 323-325 (5th Cir. 1991) (same as to reimbursement of certain gas treatment costs), cert. denied, 502 U.S. 1058 (1992); *Hoover & Bracken Energies, Inc.* v.

a. The Secretary's interpretation of his "gross proceeds" rule in this context makes simple economic sense. As we have explained (see pages 3-4, *supra*), the contract settlements at issue in this and similar cases arose because federal lessees like petitioner had entered into long-term, fixed-price contracts for the sale of the gas they produced from their leases. Under those contracts, the lessees expected to produce and sell gas at a reasonably predictable pace and for a predictable price—on all of which they would, of course, owe a royalty to the government as lessor.

After a substantial drop in the market price of natural gas, the same lessees found themselves holding valuable contract rights to receive significantly higher prices—subject, however, to a variety of legal and business risks, such as that the purchasers would contest their continued contractual liability, would demand concessions as a condition of doing other business, or would be driven into bankruptcy. The net result was usually, as in this case, a negotiated settlement between the lessee and its purchaser, under which the purchaser paid a lump sum to the lessee in return for either a change in the price terms of the contract or a complete release from the contract's purchase obligations. See, *e.g.*, *Independent Petroleum Ass'n of America* v. *Babbitt*, 92 F.3d 1248, 1251-1252 (D.C. Cir. 1996) (*IPAA*).

United States Dep't of Interior, 723 F.2d 1488, 1491-1492 (10th Cir. 1983) (tax reimbursement), cert. denied, 469 U.S. 821 (1984); *Wheless Drilling Co.*, 80 Interior Dec. 599 (1973) (same); *Kerr-McGee Oil Indus. Inc.*, 70 Interior Dec. 464, 469-470 (1963) (same); see also *Pennzoil Exploration & Prod. Co.* v. *Lujan*, 751 F. Supp. 602, 605-606 (E.D. La. 1990), aff'd, 928 F.2d 1139 (TECA 1991) (sales under special statutory incentive program).

In either case, of course, the lessee in fact continued to produce gas under its federal leases; and it continued to sell that gas, at a new price, either to the original purchaser or to third parties. Thus, as an economic matter, the lessee would generally produce and sell all of the gas that had been committed under a settled contract, for an effective price equal to (i) the per-unit price received for gas produced after the settlement, plus (ii) the amount previously received in settlement of the original purchaser's previous contractual obligation to purchase the same gas (generally at a higher per-unit price). Under those circumstances, the Secretary reasonably concluded that a federal lessee should calculate the royalties it owes to the public not only on the amount received for usually lower-price purchases after the settlement, but on the whole amount, including the settlement payment, that the lessee actually received from purchasers in respect of gas produced and sold under its lease.

b. The fact that high-price purchase obligations were typically, as here, settled with lump-sum payments presented a further issue concerning the *timing* of a lessee's royalty obligations. A similar question had previously arisen in the context of take-or-pay payments, which are made as a lump sum in one period and then often may be applied in increments to "make-up" gas taken by the purchaser in later periods. See page 3, *supra*. Originally, the Secretary took the position that take-or-pay payments were always part of the consideration for any gas purchased under a particular contract, and that they were therefore subject to royalties at the time they were made. See, *e.g.*, 30 C.F.R. 206.151 (1988) (including take-or-pay payments within the definition

of "gross proceeds"); 53 Fed. Reg. 1184, 1194-1195, 1230, 1241-1242 (1988).

The Fifth Circuit rejected that position in *Diamond Shamrock Exploration Co.* v. *Hodel*, 853 F.2d 1159 (1988), holding instead that the relevant statutory, regulatory and contractual provisions called for royalties only on "the value of *production* * * * from the leased property," and that royalties therefore did not become due on any payment "unless and until actual production, the severance of minerals from the formation, occurs." *Id.* at 1165. Thus, in the court's view, a take-or-pay payment *did* give rise to a royalty obligation—but only when, and to the extent that, the quantity of untaken gas to which it related was later produced and delivered as "make-up" gas. *Id.* at 1167-1168.

The Secretary chose not to continue litigating the question at issue in *Diamond Shamrock*, which was (as the court below recognized, Pet. App. 10a) largely one of timing. Instead, the Secretary's "gross proceeds" regulation was amended to delete the requirement that take-or-pay payments be included in a lessee's "gross proceeds" when received. 53 Fed. Reg. 45,082 (1988). As the court below noted (Pet. App. 12a), however, the Secretary continued to require the payment of royalties on such payments if and when the untaken gas was subsequently produced and sold. See 53 Fed. Reg. 45,083 (1988).[6]

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[6] In responding to *Diamond Shamrock*, the Secretary emphasized that the "changes to the regulations * * * [were] consistent with, and [were] the minimum necessitated by, the Fifth Circuit's * * * decision." 53 Fed. Reg. 45,084 (1988). He further cautioned that production-value determinations would continue to be "premised on the concept that royalty value cannot be less than the gross proceeds accruing to the

The issue of the treatment of lump-sum settlement payments arose against this backdrop. The Secretary accordingly adopted a position consistent both with *Diamond Shamrock* and with his subsequent treatment of take-or-pay payments. In two final decisions issued by his delegates, the Secretary concluded that lump-sum settlement payments should be incrementally attributed to gas originally required to be taken under the settled contract, the purchase price of which had been modified as a result of the settlement payment. *Shell Offshore, Inc.*, MMS-91-0087-OCS (Sept. 2, 1994); *Samedan Oil Corp.*, MMS-94-0003-IND (Sept. 16, 1994). If that gas was produced and sold after the settlement (and during the term of the original contract), an allocable portion of the settlement payment would be subject to royalty at the time of production. If some or all of the gas subject to the original contract was never produced, then no royalty would be owed on the corresponding portion of the settlement.

That sensible position is the one advanced by the Secretary in this case. As the court of appeals held (Pet. App. 8a-16a), requiring the payment of royalties on the entire amount received by petitioner for gas that it produced and sold under a federal lease simply applies the governing principles supplied by the Act, the Secretary's regulations, and petitioner's lease to the economic realities of petitioner's situation. In addition, even if the matter were debatable, the

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lessee," and that his delegates would "carefully review all situations to ensure that lessees do not improperly attempt to use contractual devices to avoid royalties by denominating as take-or-pay or advance payments other consideration which is part of the gross proceeds for production." *Ibid.*

Secretary's regulatory implementation of the federal leasing statutes that Congress has charged him to administer is entitled to deference, see *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-845 (1984); and his construction of his own regulations, including the value-of-production and "gross proceeds" rules in 30 C.F.R. 206.151 and 206.152(h), is entitled to "controlling weight." *Security Servs., Inc.* v. *K Mart Corp.*, 511 U.S. 431, 436 n.2 (1994); see also, *e.g.*, *Auer* v. *Robbins*, 117 S. Ct. 905, 911 (1997); *Stinson* v. *United States*, 508 U.S. 36, 45 (1993); *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965); *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945). The court of appeals therefore correctly rendered judgment in favor of the Secretary in this case.

2. We agree with petitioner (Pet. 12-14), however, that the decision in this case, upholding the Secretary's right to receive royalties from petitioner with regard to a contract settlement payment, conflicts in principle with the D.C. Circuit's decision in *Independent Petroleum Association of America* v. *Babbitt*, *supra*. The straightforward legal issue involved here is an important one both to the government and to federal lessees, and review at this time would enable all affected parties, and the courts, to avoid a considerable amount of protracted and ultimately unproductive litigation. We therefore concur in petitioner's request that the Court grant review and resolve the issue in this case.

a. *IPAA* reversed the Secretary's decision in *Samedan Oil*, one of the two administrative decisions that first applied the Secretary's interpretation of the "gross proceeds" rule in the settlement-payment con-

text. See page 15, *supra*.[7] In *Samedan*, the Secretary assessed royalties on a payment received by a lessee in exchange for settlement of accrued but unpaid take-or-pay liabilities and a release from any future purchase obligations under a contract, to the extent that the lessee later produced and sold (to a third party) the gas originally committed under the settled contract.

The D.C. Circuit rejected the Secretary's position. 92 F.3d at 1258-1260. Concluding that settlement payments were "functionally indistinguishable" from take-or-pay payments for royalty purposes, the court held that it was "arbitrary and capricious" for the Secretary to attempt to collect royalties on such payments, when in the take-or-pay context he had "read *Diamond Shamrock* as requiring a link between royalty-bearing payments and severed gas and * * * regulated accordingly." *Id.* at 1260. In evaluating the presence or absence of such a "link," the D.C. Circuit, unlike the Secretary, focused exclusively on whether a payment received by the lessee was subject to some explicit contractual recoupment provision:

> The relevant question * * * is whether or not the funds making up the payment actually pay for any gas severed from the ground. When take-or-pay payments (or settlement payments) are

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[7] Samedan's case was consolidated with a challenge by an industry trade association to the views expressed in a letter to royalty payors dated May 3, 1993—before the agency's decisions in *Samedan* and *Shell Offshore*—from an Associate Director of the Department of the Interior's Minerals Management Service. See *IPAA*, 92 F.3d at 1253-1255. The court ultimately held that the May 3 letter was not subject to review as an agency "rule," because it "did not bind the agency in any way." *Id.* at 1256-1257.

> recouped, those funds do pay for severed gas. But when the payments (of either variety) are non-recoupable, the funds are never linked to any severed gas. * * * Neither take-or-pay payments nor take-or-pay settlement payments are royalty bearing unless and until they are credited toward the purchase of make-up gas.

Id. at 1260. Thus, the court held, in effect, that the only cognizable "link" was an express contractual provision like the one involved in *Diamond Shamrock* —that is, the link established when all or part of a take-or-pay payment is explicitly credited against the price of "make-up" gas that is later produced and sold by the lessee to the same purchaser under the same contract.

b. The reasoning of the *IPAA* decision conflicts with that of the decision below in two important respects, both of which go to the heart of why this case was correctly decided, and *IPAA* was not.

1. First, *IPAA* improperly adopted a very narrow and formalistic view of the "link" between a particular payment and the production of gas that is necessary for the government, as owner of the gas in question and grantor of the development rights being exploited by the lessee, to claim a royalty. By focusing on its take-or-pay analogy and speaking in terms of payments "credited toward the purchase of make-up gas" (92 F.3d at 1260), the D.C. Circuit suggested that it would look for the existence of an explicit provision tying past payments to future production through some formal contractual accounting mechanism.

That approach contrasts sharply with the reasoning of the Sixth Circuit in this case. See Pet. App.

10a-12a. The decision below recognized the need, under *Diamond Shamrock* and the Secretary's regulations, for "some nexus with production" to permit the assessment of royalties on a particular payment. *Id.* at 10a. The court rejected, however, the formalistic analysis advanced by petitioner, under which no such "nexus" could exist because the settlement payment was made to extinguish one set of contracts, while any gas produced and sold after the settlement was covered by a new set of documents. See *id.* at 7a-8a & n.4, 11a-12a. The court looked instead to the economic realities of the situation, treated the parties' various formal contractual arrangements as functionally "one transaction" (*id.* at 8a), and held that "the necessary nexus to production exists under the facts of th[is] case" (*id.* at 11a). See also *id.* at 12a (liability for royalties does not turn on whether the lessee used "one piece of paper" or "two pieces of paper" to document its agreements).

The functional analysis employed by the court below, focusing on the economic substance of the transactions at issue rather than on their contractual form, is consistent with the Secretary's longstanding approach to royalty issues. See page 11 & note 5, *supra*. It is also consistent with the holdings of courts that have considered leases among private parties, interpreting them in accordance with state law and the basic purposes of mineral development leases. See *Klein* v. *Jones*, 980 F.2d 521, 527-532 (8th Cir. 1992) (discussing principles and other cases), cert. denied, 117 S. Ct. 65 (1996); *Frey* v. *Amoco Prod. Co.*, 943 F.2d 578, 580-586 (5th Cir. 1991) ("It would be contrary to the nature of the lease as a cooperative venture to allow a benefit *by any name* that is attributable to the gas under the leased premises to inure

exclusively to the lessee.") (*id.* at 584) (emphasis added), withdrawn in part, 951 F.2d 67, reinstated, 976 F.2d 242 (1992); *Frey* v. *Amoco Prod. Co.*, 603 So. 2d 166 (La. 1992); see also D. Harrell, *Developments in Nonregulatory Oil and Gas Law*, 30 Inst. on Oil & Gas L. & Tax'n 311, 336-337 (1979) ("[A]ny determination of the market value of gas which * * * permits either the lessor or the lessee to receive a part of the gross revenues from the property greater than the fractional division contemplated by the lease, should be considered inherently contrary to the basic nature of the lease."). The same sort of analysis led the Secretary's delegate to reach the decision that she did in *Samedan*. See, *e.g.*, *IPAA*, 92 F.3d at 1254 (quoting agency decision). That functional approach cannot, however, be reconciled with the highly formal analysis that led the D.C. Circuit to overturn the *Samedan* decision in *IPAA*.

2. The second fundamental conflict between *IPAA* and the decision below involves the two courts' different willingness to respect the Secretary's decisions concerning how to administer the OCSLA and how to interpret and apply his own regulations. The court of appeals in this case correctly held that the Secretary's present position is entirely consistent with *Diamond Shamrock* (see Pet. App. 9a-12a). Indeed, the court explicitly pointed out that the Secretary, in amending his regulations to accommodate that decision, had "never conceded" that he would not seek royalties in a case like this one, "once a sufficient link to production [was] established." *Id.* at 12a; see note 6, *supra*.

The *IPAA* court, on the other hand, premised its entire decision on a supposed inconsistency between the Secretary's position in *Samedan* and his "*adop-*

tion and application of *Diamond Shamrock*." 92 F.3d at 1259; see also, *e.g.*, *id.* at 1258 ("[I]f [the Secretary's] interpretation of the gross proceeds rule is unreasonable, it is unreasonable because the application of that interpretation in the case of * * * settlement payments constitutes an unexplained departure from the agency's adoption of *Diamond Shamrock*."). That analysis depends, of course, on the court's attribution to the Secretary of an intention to acquiesce, in his post-*Diamond Shamrock* regulatory amendments, in the broad interpretation of the Fifth Circuit's decision that the *IPAA* panel majority itself later adopted. See, *e.g.*, *id.* at 1260 & n.3 (after "adopting" a court decision, an agency may not treat two cases differently "where the rationale of the court decision applies to both"). The court's imputation of that intention to the Secretary was improper, however, because it is the Secretary's prerogative to tailor or limit the regulations that he adopts in the first instance—and to interpret them later, in accordance with his own permissible constructions of the statutes that he administers and, in this case, of what he regards as "the minimum [regulatory change] necessitated by" a particular court decision. 53 Fed. Reg. 45,084 (1988); see note 6, *supra*. The court of appeals in this case understood and observed that principle, see Pet. App. 11a-12a, and its rejection of petitioner's argument "that the government's response to *Diamond Shamrock* foreclosed its approach to the instant case" (*id.* at 11a) conflicts directly with the D.C. Circuit's acceptance of the same argument in *IPAA*.

c. The court below sought to distinguish *IPAA* on the ground that this case involved a continuing contractual relationship with one purchaser, whereas

IPAA involved substituted sales of gas to a third party. Pet. App. 6a n.2, 14a-15a. We note, however, that the Secretary's interpretation of his regulations—argued both below and in *IPAA*—draws no such distinction. Although the court below explicitly reserved judgment on the point (see *id.* at 6a n.2), its adoption of a functional analysis consistent with the Secretary's approach, and its evident willingness to accept the Secretary's construction of his own regulations, strongly suggest that, so long as the appropriate "nexus" could be shown, it would agree with the Secretary's assessment of royalties even in a case like *Samedan* that involved a third-party purchaser.[8]

Whether the D.C. Circuit might, if presented with a case like this one, limit its holding in *IPAA* to third-party situations is a more difficult question. The district court in which the *IPAA* case is now pending on remand has attempted (over the government's objection) to distinguish that case from the decision below, on the ground that *IPAA* dealt only with "true nonrecoupable take-or-pay payments or settlement payments," while the Sixth Circuit in this case merely "saw through" the parties' attempt to "avoid make-up contracts, which would be subject to royalties." *IPAA* v. *Babbitt*, 971 F. Supp. 19, 32-33 (D.D.C. 1997) (*IPAA II*). Should the matter return to the D.C. Circuit, the government is prepared to argue

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[8] The substituted "third-party" contract at issue in *Samedan* and *IPAA* was signed on the same day as the settlement agreement that gave rise to the lump-sum payment. 92 F.3d at 1254. That circumstance implies that the two agreements were, from Samedan's point of view, part of one overall business transaction. The particular facts at issue in *IPAA* were therefore very close to those in this case. Compare Pet. App. 5a, 8a-9a.

that some such limiting recharacterization of the original *IPAA* decision, to accommodate at least a degree of functional rather than purely formal analysis, would be preferable to any extension of that decision to its logical extreme. Given, however, the *IPAA* court's focus on whether settlement funds "actually pay for * * * gas" by being "credited toward the purchase of make-up gas" (92 F.3d at 1260), and its refusal to accept the Secretary's explanation of his own regulatory intentions, discussed above, there is considerable reason to question the likelihood that the D.C. Circuit will retreat from the sterile formalism of its first opinion. In the meantime, both the underlying issue in these cases and continuing arguments over the exact legal and geographical scope of the D.C. Circuit's decision in *IPAA* will continue to generate a good deal of essentially unproductive litigation. See *IPAA II*, *supra*.[9] There is therefore little reason for the Court to postpone review of this case in order to await further developments in the lower courts.[10]

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[9] In *IPAA II*, the trade association plaintiff has urged the district court to impose a nationwide injunction barring the Secretary from endeavoring to recover royalties on contract settlement payments, including further consideration of pending administrative appeals. See 971 F. Supp. at 23-24. The plaintiff's motion to alter or amend the court's initial judgment rejecting that request is still pending. In the meantime, the district court has already enjoined the Secretary from pursuing additional administrative proceedings involving Samedan Oil itself—including proceedings involving payments that were not at issue in the original Samedan litigation. *Id.* at 30-35.

[10] A federal lessee is generally entitled to seek judicial review of a final royalty assessment by filing suit against the Secretary in the District of Columbia. See 28 U.S.C. 1391(e). Because lessees may be expected to seek maximum advantage

3. Proper resolution of the question presented in this case will directly affect the Secretary's ability to recover very substantial royalties due under leases for the development of public and Indian natural gas resources. One study of contract settlements estimated that from 1982 through 1990, federal and Indian gas lessees received a total of approximately $4.6 billion in contract settlement payments (out of a total of approximately $10 billion in such payments received by all lessees), with an estimated total potential royalty yield of $754 million. U.S. Dep't of the Interior, Office of the Inspector General, *Audit Report No. 92-I-657: Gas Contract Settlements, Minerals Management Service* 4 (March 1992). We are informed that more recent estimates, based on data reported to the Secretary by lessees, suggest total settlement payments through 1993 on the order of $18 billion, a substantial proportion of which would have related at least in part to gas covered by federal or Indian leases. Those leases generally provide for royalties of between 12.5% and 16% of the lessee's "gross proceeds." The Secretary estimates that, to date, he has collected approximately $200 million in royalties on settlement payments, and that perhaps another $70 million in royalties is at issue in the more than 150 appeals that are presently pending

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from the decision in *IPAA*, future litigation is likely to be concentrated in the D.C. Circuit. While that fact may mute the potential for disparate results that normally arises from a conflict in the circuits, it also magnifies the very substantial damage (discussed below) inflicted by the error in *IPAA*; deprives the government of the opportunity to litigate the issue in other circuits; and correspondingly lessens any advantage that might otherwise accrue from allowing further consideration of the matter by various courts of appeals.

before the Director of the Department of the Interior's Minerals Management Service.[11] More than 500 additional settlements have not yet been audited.[12]

Under the functional approach adopted by the court of appeals in this case, the Secretary would be able to administer the relevant statutes and his own regulations to ensure that those sizable settlement payents do not become mere windfalls to lessees. So long as a functional "link" or "nexus" could be shown between a settlement payment and the lessee's subsequent production and sale of gas under its leases, the Secretary could properly require that that payment be shared with the owners of the gas produced and sold, in accordance with the terms of the lease. By contrast, the formalistic analysis embraced by the D.C. Circuit in *IPAA* would evidently allow lessees to avoid paying royalties on amounts (i) received from customers, (ii) in settlement of gas purchase obliga-

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[11] Final adminstrative decisions in 134 of those appeals must be issued by May 13, 1999, under amendments made by the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, Pub. L. No. 104-185, § 4(a), 110 Stat. 1709 (enacting a new provision to be codified at 30 U.S.C. 1724(h)). By enacting new time limits for administrative decisions, Congress has indicated a specific interest in the timely resolution of royalty disputes. Definitive resolution of the widely relevant issue presented in this case would contribute materially toward the realization of that goal.

[12] We are informed that some federal coal lessees have also begun to contend, on the basis of *IPAA*, that the Secretary may not recover royalties on settlement payments made with respect to coal purchase contracts, because those contracts do not contain express "recoupment" provisions. The statutory and regulatory provisions applicable to royalties on federal coal leases are similar to those at issue in this case. See 30 U.S.C. 207(a); 30 C.F.R. 206.251, 206.257.

tions, (iii) fairly allocable to gas originally committed under the settled contract, and (iv) later actually produced and sold by the lessee, so long as the relevant contracts do not expressly refer to those amounts as part of the overall price received for later-sold gas. That exaltation of form over substance permits obvious and wholly inappropriate opportunities for the manipulation of royalty amounts by lessees and gas purchasers—who share, in that regard, a common economic interest quite adverse to that of the public and Indian lessors whose interests it is the Secretary's duty to protect. See, *e.g.*, *Klein*, 980 F.2d at 531; see also Pet. App. 15a-16a ("It is important to remember that Century and other producers do not own the land that is the subject of these leases."); 43 U.S.C. 1332(3) ("the outer Continental Shelf is a vital national resource reserve *held by the Federal Government for the public*" (emphasis added)).[13]

The decision in this case makes clear that there is, at a minimum, serious reason to doubt the correct-

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[13] Congress has previously manifested its concern with effective enforcement of royalty obligations on federal and Indian leases. Concerned that what was essentially an "honor system" of royalty collection had proved ineffective (see H.R. Rep. No. 859, 97th Cong., 2d Sess. 15 (1982)), Congress enacted the Federal Oil and Gas Royalty Management Act of 1982, Pub. L. No. 97-451, 96 Stat. 2447 (1983) (codified at 30 U.S.C. 1701 *et seq.*). That Act states Congress's finding that the then-existing system for accounting for royalties was "archaic and inadequate," and its intention that the Secretary "develop[] * * * enforcement practices that ensure the prompt and proper collection * * * of oil and gas revenues owed to the United States and Indian lessors" and "aggressively carry out his trust responsibility in the administration of Indian oil and gas." 30 U.S.C. 1701.

ness of the decision in *IPAA*. We believe that the *IPAA* court erred, both in interpreting the applicable law and regulations and in failing to defer to the Secretary's contrary determinations. Those errors, if not corrected by this Court, will largely control future litigation on this issue (see note 10, *supra*), and they will cause very significant damage to the public fisc and to financial interests that are often of critical importance to Indian lessors, to whom the United States owes an important trust responsibility. For all these reasons, we agree with petitioner that the first question presented warrants review and resolution by this Court.

CONCLUSION

With respect to the first question presented, the petition for a writ of certiorari should be granted. In all other respects, the petition should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

October Term, 1997

CENTURY OFFSHORE MANAGEMENT CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari To The United States Court of Appeals For the Sixth Circuit

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1. In its response, the United States concurs in Petitioner's request for this Court to review the issue of whether the Department of the Interior ("DOI") is precluded from claiming royalties on non-recoupable settlement payments made by oil and gas purchasers on the ground that such royalty claims exceed DOI's statutory authority under the Outer Continental Shelf Lands Act ("OCSLA"), 43 U.S.C. § 1331 *et seq.* U.S. Br. at 11. In a brief footnote, however, the United States takes the position that this Court should not review whether the United States Court of Appeals for the Sixth Circuit, in reversing a bankruptcy court's grant of summary judgment, exceeded its appellate authority by improperly applying a *de novo* standard of review to the bankruptcy court's findings of fact rather than the clearly erroneous standard of review. *Id.* at 11 n.4.

2. But the Government's position is incorrect. According to the Government, the Sixth Circuit's decision was not based on *de novo* findings of fact but "on the court's evaluation and construction of the parties' overall contractual relationship -- a legal issue properly subject to *de novo* review." *Id.* However, the interpretation of an "overall contractual relationship" -- i.e., where matters outside of the four walls of the particular contract at issue are considered -- is not a pure question of law but is instead a question of fact. *See Sanitary Farm Dairies, Inc. v. Gammel*, 195 F.2d 106, 117 (8th Cir. 1952) ("Ascertainment of what the terms of a contract actually are, where they are ambiguous and where the extrinsic evidence to illuminate is not of unequivocal effect, is functionally a matter of fact-determination"); *Blue Cross & Blue Shield Ass'n v. United States*, 17 Cl. Ct. 558, 564 (1989) (when interpretation of contract provision rests on parol evidence issue becomes question of fact rather than law).[1] As Professor Corbin has explained:

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[1] As explained below, the Sixth Circuit's ultimate interpretation of the parties "overall contractual relationship" was not simply a function of the textual interpretation of a contract or contracts, and in any event, where

> Not infrequently, both the existence and the terms of a contract must be determined by inferences to be drawn from letters, conduct, and oral statements of the parties. If from the whole material thus adduced more than one inference may reasonably be drawn, the determination of the inferences to be drawn -- the interpretation -- is for the jury or other trier of the facts. (footnote omitted).

3 Arthur L. Corbin, *Corbin on Contracts* § 554, at 226-27 (1960).[2] Thus, the Government's assertion that the Sixth Circuit acted properly in performing a *de novo* review of the "overall contractual relationship" between Petitioner and the purchaser of its natural gas is incorrect.

3. Nor can there be any doubt that the Sixth Circuit made a *de novo* review of the facts surrounding the "overall contractual relationship" between the parties. The record before the Sixth Circuit was the same that was before the bankruptcy court. On the basis of the extrinsic evidence in that record, which it found to be undisputed, the bankruptcy court found that Enron had offered to extinguish its non-recoupable take-or-pay obligations under the Fixed-Price Contracts and had engaged in negotiations with Petitioner in which the parties ultimately agreed that the present value of

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the terms of one contract are interpreted by consideration of another, that is parol evidence as to the first contract.

[2] Corbin posits that simple textual interpretation of *unambiguous* contracts is also a question of fact, even though such interpretation is provided by the court:

> The question of interpretation of language and conduct -- the question of what is the meaning that should be given by a court to the words of a contract, is a question of fact, not a question of law.... There is no "legal" meaning, separate and distinct from some person's meaning in fact.

3 Arthur L. Corbin, *Corbin on Contracts* § 554, at 218 (1960).

Enron's remaining payments under the Fixed-Price Contracts was $12.25 million in the event Enron never purchased any additional gas under those contracts. On the basis of that same undisputed extrinsic evidence and an admission by the Government at oral argument, the bankruptcy court also found that the parties did not negotiate for a reduced price for gas to be purchased in the future under the Spot-Price Contracts and that, as a result, no part of the $12.25 million settlement payment was an advance payment for gas to be purchased under the spot contracts. However, after conducting its own review of the record, including presumably the extrinsic evidence that was adduced by each party, the Sixth Circuit concluded, contrarily to the evidence submitted by Petitioner, that no part of $12.25 million settlement payment was intended by the parties to extinguish Enron's admitted obligation to make take-or-pay payments during the remaining years of the Fixed-Price Contracts. Rather, the Sixth Circuit determined that the entire lump sum settlement payment acted as a prepayment for gas that Enron bought under the Spot-Price Contracts, even though Enron had no right or obligation under those contracts to purchase a minimum quantity of gas from Petitioner. Thus, there can be no doubt that the Sixth Circuit improperly substituted its own view of the "overall contractual relationship" between the parties in place of the findings of fact that were made by the bankruptcy court and affirmed on appeal to the district court. The standard of review question raised by Petitioner therefore merits review by this Court just as much as the underlying issue of whether the Government is entitled under OCSLA to royalties on non-recoupable payments made to settle non-recoupable take-or-pay liabilities.

4. The procedural posture of this case constitutes an additional reason for granting review of Petitioner's second issue. The Sixth Circuit has not only reversed the bankruptcy court's grant of summary motion to Petitioner but granted the Government's motion for summary judgment. However, the Government's motion was filed only three days prior to the bankruptcy court's hearing on Petitioner's motion. When

Petitioner's motion was granted, the Government's motion became moot. As a result, Petitioner has never been given an opportunity to file an opposition to the Government's unverified motion, to rebut the extrinsic evidence that the Government submitted in support of its motion, or to have a hearing on that motion. Consequently, the improper fact finding by the Sixth Circuit also has deprived Petitioner of the most basic right to due process of law.

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